

SONIC FOUNDRY INC  
Form 10-Q  
January 29, 2010  
Table of Contents

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

**FORM 10-Q**

(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, 2009

OR

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

Commission File Number 1-14007

**SONIC FOUNDRY, INC.**

(Exact name of registrant as specified in its charter)

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

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

**222 West Washington Ave, Madison, WI 53703**

(Address of principal executive offices)

**(608) 443-1600**

(Registrant's telephone number including area code)

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

Smaller reporting company

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
Common Stock, \$0.01 par value

Outstanding January 28, 2010
3,615,736

**Table of Contents**

**TABLE OF CONTENTS**

	PAGE NO.
<b><i>PART I FINANCIAL INFORMATION</i></b>	
Item 1. Condensed Consolidated Financial Statements	
<u>Condensed Consolidated Balance Sheets (Unaudited) December 31, 2009 and September 30, 2009</u>	3
<u>Condensed Consolidated Statements of Operations (Unaudited) Three months ended December 31, 2009 and 2008</u>	4
<u>Condensed Consolidated Statements of Cash Flows (Unaudited) Three months ended December 31, 2009 and 2008</u>	5
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	23
Item 4. <u>Controls and Procedures</u>	23
<b><i>PART II OTHER INFORMATION</i></b>	
Item 1. <u>Legal Proceedings</u>	24
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	24
Item 3. <u>Defaults Upon Senior Securities</u>	24
Item 4. <u>Submission Of Matters To A Vote Of Security Holders</u>	24
Item 5. <u>Other Information</u>	24
Item 6. <u>Exhibits</u>	25
<u>Signatures</u>	27

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

	(Unaudited) December 31, 2009	September 30, 2009
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 2,366	\$ 2,598
Accounts receivable, net of allowance of \$105 and \$105	3,516	3,741
Inventories	307	440
Prepaid expenses and other current assets	278	472
<b>Total current assets</b>	<b>6,467</b>	<b>7,251</b>
Property and equipment:		
Leasehold improvements	980	980
Computer equipment	2,565	2,545
Furniture and fixtures	461	461
<b>Total property and equipment</b>	<b>4,006</b>	<b>3,986</b>
Less accumulated depreciation	2,803	2,670
<b>Net property and equipment</b>	<b>1,203</b>	<b>1,316</b>
Other assets:		
Goodwill	7,576	7,576
Other intangibles, net of amortization of \$41 and \$35	24	30
<b>Total assets</b>	<b>\$ 15,270</b>	<b>\$ 16,173</b>
<b>Liabilities and stockholders equity</b>		
Current liabilities:		
Revolving line of credit	\$ 300	\$ 300
Accounts payable	739	636
Accrued liabilities	716	1,047
Unearned revenue	5,041	5,272
Current portion of notes payable	323	316
Current portion of capital lease obligations	14	24
<b>Total current liabilities</b>	<b>7,133</b>	<b>7,595</b>
Long-term portion of notes payable	475	557
Other liabilities	148	170
Deferred tax liability	1,310	1,250
<b>Total liabilities</b>	<b>9,066</b>	<b>9,572</b>
Stockholders equity:		
Preferred stock, \$.01 par value, authorized 500,000 shares; none issued and outstanding		
5% preferred stock, Series B, voting, cumulative, convertible, \$.01 par value (liquidation preference at par), authorized 1,000,000 shares, none issued and outstanding		
	362	362

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Common stock, \$.01 par value, authorized 10,000,000 shares; 3,619,638 and 3,619,638 shares issued and 3,606,922 and 3,606,922 shares outstanding		
Additional paid-in capital	184,913	184,990
Accumulated deficit	(178,876)	(178,556)
Receivable for common stock issued	(26)	(26)
Treasury stock, at cost, 12,716 shares	(169)	(169)
Total stockholders' equity	6,204	6,601
<b>Total liabilities and stockholders' equity</b>	<b>\$ 15,270</b>	<b>\$ 16,173</b>

See accompanying notes

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

	Three Months Ended December 31,	
	2009	Revised 2008
<b>Revenue:</b>		
Product	\$ 1,928	\$ 1,744
Services	2,548	2,236
Other	26	29
<b>Total revenue</b>	<b>4,502</b>	<b>4,009</b>
<b>Cost of revenue:</b>		
Product	830	766
Services	190	125
<b>Total cost of revenue</b>	<b>1,020</b>	<b>891</b>
<b>Gross margin</b>	<b>3,482</b>	<b>3,118</b>
<b>Operating expenses:</b>		
Selling and marketing	2,218	2,663
General and administrative	803	783
Product development	711	903
<b>Total operating</b>	<b>3,732</b>	<b>4,349</b>
<b>Loss from operations</b>	<b>(250)</b>	<b>(1,231)</b>
Other expense, net	(10)	(9)
Loss before income taxes	(260)	(1,240)
Provision for income taxes	(60)	(36)
<b>Net loss</b>	<b>\$ (320)</b>	<b>\$ (1,276)</b>
<b>Net loss per common share:</b>		
basic and diluted	\$ (0.09)	\$ (0.36)
<b>Weighted average common shares</b>		
basic and diluted	3,606,922	3,560,788

See accompanying notes



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

	<b>Three months ended December 31,</b>	
	<b>2009</b>	<b>Revised 2008</b>
<b>Operating activities</b>		
Net loss	\$ (320)	\$ (1,276)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Amortization of other intangibles	6	2
Depreciation and amortization of property and equipment	133	156
Deferred taxes	60	36
Other non-cash items		(2)
Share-based compensation expense related to stock warrants and options	(77)	205
Provision for doubtful accounts		(30)
Changes in operating assets and liabilities:		
Accounts receivable	225	1,287
Inventories	133	12
Prepaid expenses and other current assets	194	(1)
Accounts payable and accrued liabilities	(228)	(304)
Other long-term liabilities	(22)	(21)
Unearned revenue	(231)	(55)
Net cash provided by (used in) operating activities	(127)	9
<b>Investing activities</b>		
Purchases of property and equipment	(20)	(131)
Net cash used in investing activities	(20)	(131)
<b>Financing activities</b>		
Payments on notes payable	(75)	(84)
Proceeds from exercise of common stock options		15
Payments on capital lease obligations	(10)	(13)
Net cash used in financing activities	(85)	(82)
Net decrease in cash	(232)	(204)
Cash and cash equivalents at beginning of period	2,598	3,560
Cash and cash equivalents at end of period	\$ 2,366	\$ 3,356

See accompanying notes



**Table of Contents**

**Sonic Foundry, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**December 31, 2009**

**(Unaudited)**

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

Sonic Foundry, Inc. (the Company) is in the business of providing enterprise solutions and services for the web communications market.

***Interim Financial Data***

The accompanying unaudited condensed 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, 2009. In the opinion of management, all adjustments (consisting only of adjustments of a normal and recurring nature) considered necessary for fair presentation of the results of operations have been included. Operating results for the three month period ended December 31, 2009 are not necessarily indicative of the results that might be expected for the year ending September 30, 2010.

***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 collectability 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 exchange or repair pursuant to a warranty or stock rotation. The Company's policy is to reduce revenue if it incurs an obligation for price rebates or other such programs during the period the obligation is reasonably estimated to occur. The following policies apply to the Company's major categories of revenue transactions.

**Products**

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

**Services**

We sell support contracts to our 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 on a when and if available basis, advance hardware 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, training, event webcasting, and customer content hosting services. Revenue for those services is recognized when performed in the case of installation, training and event webcasting services and is recognized ratably over the contract period for content hosting services. Service amounts invoiced to customers in excess of revenue recognized are recorded as deferred revenue until the revenue recognition criteria are met.

## **Table of Contents**

### Revenue Arrangements that Include Multiple Elements

Revenue for transactions that include multiple elements such as hardware, software, installation, training, and post customer support is allocated to each element based on vendor-specific objective evidence of the fair value ( VSOE ) in accordance with FASB ASC-985-605. Revenue is recognized for each element when the revenue recognition criteria have been met for that element. VSOE is based on the price charged when the element is sold separately. If VSOE of fair value does not exist for all elements in a multiple element arrangement, 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.

### Reserves

We record reserves for stock rotations, price adjustments, rebates, and sales incentives to reduce revenue and accounts receivable for these and other credits we may grant to customers. Such reserves are recorded at the time of sale and are calculated based on historical information (such as rates of product stock rotations) and the specific terms of sales programs, taking into account any other known information about likely customer behavior. If actual customer behavior differs from our expectations, additional reserves may be required. Also, if we determine that we can no longer accurately estimate amounts for stock rotations and sales incentives, we would not be able to recognize revenue until resellers sell the inventory to the final end user.

### Shipping and Handling

The Company's shipping and handling costs billed to customers are included in other revenue. Costs related to shipping and handling are included in cost of revenue and are recorded at the time of shipment to the customer.

### **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.

### ***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.

**Table of Contents*****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):

	12/31/09	9/30/09
Raw materials and supplies	\$ 10	\$ 10
Finished goods	297	430
	\$ 307	\$ 440

***Fair Value of Financial Instruments***

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

***Stock Based Compensation***

On March 5, 2009, Stockholders approved adoption of the 2009 Stock Incentive Plan (the 2009 Plan) which provides for issuance of options to purchase up to 400,000 shares of common stock. The 2009 Plan replaced both a qualified stock option plan and a non-qualified stock option plan which expired on October 1, 2009. The Company also maintains a directors' stock option plan under which options may be issued to purchase up to an aggregate of 50,000 shares of common stock. Each non-employee director, who is re-elected or who continues as a member of the board of directors on each annual meeting date and on each subsequent meeting of Stockholders, will be granted options to purchase 2,000 shares of common stock under the directors' plan, or at other times or amounts at the discretion of the Board of Directors.

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 fair market value 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.

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, 2009.

The Company uses a lattice valuation model to account 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 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 the options are expected to be outstanding is based on the U.S. Treasury yields in effect at the time of grant.

**Table of Contents**

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

	<b>Three months ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
Expected life	5.5 years	5.9 years
Risk-free interest rate	1.37%	1.63%
Expected volatility	87.16%	80.21%
Expected dividend yield	0%	0%

A summary of option activity as of December 31, 2009 and changes during the three months then ended is presented below:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Period	Aggregate Intrinsic Value
Outstanding at October 1, 2009	766,615	\$ 16.20	6.5	\$ 91,499
Granted	24,950	5.29	9.9	
Exercised				
Forfeited	(20,301)	18.98	3.0	
Outstanding at December 31, 2009	771,264	15.75	6.3	16,711
Exercisable at December 31, 2009	512,080	\$ 20.04	4.9	\$ 15,967

A summary of the status of the Company's non-vested shares and changes during the three month periods ended December 31, 2009 and 2008 are presented below:

Non-vested Shares	Shares	<b>2009</b>		<b>2008</b>	
		Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value	Shares
Non-vested at October 1,	301,015	\$ 5.13		197,244	
Granted	24,950	3.17	103,950	2.90	103,950
Vested	(52,937)	8.09	(77,756)	5.80	(77,756)
Forfeited	(13,844)	5.07	(6,033)	8.80	(6,033)
Non-vested at December 31,	259,184	\$ 4.34	217,405	\$ 6.10	217,405

The weighted average grant date fair value of options granted during the three months ended December 31, 2009 was \$3.17. As of December 31, 2009, there was \$484 thousand of total unrecognized compensation cost related to non-vested share-based compensation, net of \$227 thousand of estimated forfeitures. The cost is expected to be recognized over a weighted-average remaining life of 1.6 years.

Due to forfeitures, stock-based compensation recorded in the three month period ended December 31, 2009 was negative \$77 thousand and was allocated \$51 thousand to selling and marketing expenses, \$5 thousand to general and administrative expenses and \$21 thousand to product development expenses. Cash received from option exercises under all stock option plans for the three month period ended December 31, 2008 was \$15 thousand. There were no options exercised in the three month period ended December 31, 2009. There were no tax benefits realized for tax deductions from option exercises in either of the three month periods ended December 31, 2009 or 2008. The Company currently expects to satisfy share-based awards with registered shares available to be issued.



**Table of Contents**

The Company also has an Employee Stock Purchase Plan (Purchase Plan) under which an aggregate of 50,000 common shares may be issued. All employees who have completed 90 days of employment with the company on the first day of each offering period are eligible to participate in the Purchase Plan. An employee who, after the grant of an option to purchase, would hold common stock and/or hold outstanding options to purchase stock possessing 5% or more of the total combined voting power or value of the company will not be eligible to participate. Eligible employees may make contributions through payroll deductions of up to 10% of their compensation. No participant in the Purchase Plan is permitted to purchase common stock under the Purchase Plan if such option would permit his or her rights to purchase stock under the Purchase Plan to accrue at a rate that exceeds \$25,000 of the fair market value of such shares, or that exceeds 1,000 shares, for each calendar year. The company makes a bi-annual offering to eligible employees of options to purchase shares of common stock under the Purchase Plan on the first trading day of January and July. Each offering period is for a period of six months from the date of the offering, and each eligible employee as of the date of offering is entitled to purchase shares of common stock at a purchase price equal to the lower of 85% of the fair market value of common stock on the first or last trading day of the offering period. There were 7,014 shares purchased by employees for the six month offering ended December 31, 2009. These shares were issued in January 2010 and the Company had an accrued liability for the employee deferrals of \$29 thousand at December 31, 2009.

**Per share computation**

Basic and diluted net loss per share information for all periods is presented under the requirements of FASB ASC-260-10. Basic earnings (loss) per share has been computed using the weighted-average number of shares of common stock outstanding during the period, less shares that may be repurchased, and excludes any dilutive effects of options and warrants. If the Company had reported net income during the periods presented below, diluted net income per share would have been computed using common equivalent shares related to outstanding options and warrants to purchase common stock. The numerator for the calculation of basic and diluted earnings per share is net income (loss). The following table sets forth the computation of basic and diluted weighted average shares used in the earnings per share calculations:

	<b>Three months ended December 31,</b>	
	<b>2009</b>	<b>2008</b>
Denominator for basic earnings per share - weighted average common shares	3,606,922	3,560,788
Effect of dilutive options and warrants (treasury method)		
Denominator for diluted earnings per share - adjusted weighted average common shares	3,606,922	3,560,788
Options and warrants outstanding during each period, but not included in the computation of diluted earnings per share because they are antidilutive	818,651	770,264

**New Accounting Pronouncements**

In September 2006, the FASB issued guidance, which provided enhanced guidance for using fair value to measure assets and liabilities. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The Standard does not expand the use of fair value in any new circumstances. The adoption of this standard on October 1, 2008 for financial assets and liabilities did not have a material effect on the Company's results of operations or financial position. In February 2008, the FASB issued additional guidance which deferred the effective date for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (that is, at least annually), to fiscal years beginning after November 15, 2008. Early adoption is permitted. The adoption of this standard related to non financial assets and liabilities on October 1, 2009 did not have a material effect on the Company's results of operations or financial position other than requiring additional disclosures for those items where non-recurring fair valuing of certain assets is performed.

**Table of Contents**

In April 2009, the FASB issued guidance concerning interim disclosures about fair value of financial instruments requiring publicly traded companies to provide disclosure about the fair value of financial instruments whenever interim summarized financial information is reported. Previously, disclosures about the fair value of financial instruments were only required on an annual basis. Disclosure shall include the method(s) and significant assumptions used to estimate the fair value of financial instruments and shall describe changes in method(s) and significant assumptions, if any, during the period. This guidance was effective for interim and annual periods ending after June 15, 2009, and, as such, the Company began including this disclosure with its third quarter 2009 financial statements.

In October 2009, the FASB issued Accounting Standards Update 2009-13, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements* (ASU 2009-13) and ASU 2009-14, *Software (Topic 985) Certain Revenue Arrangements That Include Software Elements* (ASU 2009-14). ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: (i) vendor-specific objective evidence, or VSOE, or (ii) third-party evidence, or TPE, before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. These new updates are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. An entity may elect retrospective application to all revenue arrangements for all periods presented. Entities must adopt the amendments resulting from both of these ASUs in the same period using the same transition method, where applicable. The Company is currently evaluating the impact that the adoption of these ASUs will have on our consolidated financial statements.

**2. Prior Year Revisions**

During 2009, the Company identified an issue requiring revision of the prior period financial statements relating to the presentation of disclosure of Deferred Tax Liabilities. Beginning with an acquisition in fiscal year 2002, the Company has amortized Goodwill for tax purposes over a 15 year life. Goodwill is not amortized for book purposes. Annual impairment tests are performed for book purposes and the balance of goodwill is to be written down if impairment occurs. The impairment tests have not indicated any goodwill impairment.

The difference between the book and tax balance of Goodwill creates a Deferred Tax Liability and an annual tax expense. Because of the long term nature of the goodwill timing difference, tax planning strategies cannot be applied related to the Deferred Tax Liability. The balance of the Deferred Tax Liability at September 30, 2008 was \$1.1 million. This amount was disclosed in the footnotes but was omitted from the consolidated balance sheet. Management incorrectly netted the amount with the \$36 million Deferred Tax Assets, which are also disclosed in the footnotes but not recorded on the consolidated balance sheet. Because of the long-term nature of the goodwill timing difference, these amounts cannot be netted.

Management has deemed this to be not material in the prior periods presented; however, management has elected to revise the statements under the guidance of SEC SAB 108 as the difference between book and tax goodwill, i.e., the Deferred Tax Liability, will continue to increase and could become material in future periods.

Management correctly recorded the Deferred Tax Liability and corresponding expense in fiscal year 2009 and corrected prior year amounts on the financial statements and disclosures beginning with this fiscal year 2009 10-K filing.

**Table of Contents**

The following table discloses selected Q1-2009 financial information as originally presented and as revised.

Statement of Operations (in thousands except share and per share data)	Three Months Ended December 31, 2008		
	As Presented	Adjustments	Revised
Provision for income taxes	\$	\$ (36)	\$ (36)
<b>Net loss</b>	\$ (1,240)	\$ (36)	\$ (1,276)
<b>Loss per common share:</b>			
Basic net loss per common share	\$ (0.35)	\$ (0.01)	\$ (0.36)
Diluted net loss per common share	\$ (0.35)	\$ (0.01)	\$ (0.36)
Statement of Cash Flows (in thousands)	Year Ended September 30, 2008		
	As Presented	Adjustments	Revised
Provision for income taxes	\$	\$ 36	\$ 36

**3. Related Party Transactions**

During each of the three month periods ended December 31, 2009 and 2008, the Company incurred fees of \$65 thousand and \$63 thousand, respectively, to a law firm, a partner of which is a director and stockholder of the Company. The Company had accrued liabilities for unbilled services of \$43 and \$20 thousand for the periods ended December 31, 2009 and 2008, respectively, to the same law firm.

The Company recorded Mediasite product and customer support revenue related to \$136 thousand and \$152 thousand of billings during the three month periods ended December 31, 2009 and 2008, respectively, to Mediasite KK, a Japanese reseller in which the Company has an equity interest. Mediasite KK owed the Company \$136 and \$154 thousand on billings at December 31, 2009 and 2008, respectively. The Company accounts for its investment in Mediasite KK under the equity method. The recorded value as of December 31, 2009 and 2008 is zero.

As of December 31, 2009 and 2008, the Company had a loan outstanding to an executive totaling \$26 thousand. This loan is secured by company stock.

**4. Purchase Commitments**

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. As of December 31, 2009, the Company has an obligation to purchase a remaining \$589 thousand, which is not recorded on the Company's Consolidated Balance Sheet.



## Table of Contents

### **5. Borrowing Arrangements**

On June 16, 2008, the Company and its wholly-owned subsidiary, Sonic Foundry Media Systems, Inc. (collectively, the Companies) entered into an Amended and Restated Loan and Security Agreement (the Amended Loan Agreement) with Silicon Valley Bank providing for a credit facility in the form of a \$3,000,000 secured revolving line of credit and a \$1,000,000 term loan. The ability to borrow up to the maximum \$3,000,000 amount of the revolving line of credit is determined by applying an applicable percentage to eligible accounts receivable, which, is reduced by, among other things, a reserve. Prior to the First Amendment, discussed below, the reserve was equal to the balance of the term loan when EBITDA, as defined, would have been less than \$200,000 during the preceding six month period. The revolving line of credit accrues interest at a per annum rate equal to the following: (i) during such period that Sonic Foundry maintains an Adjusted Quick Ratio (as defined) of greater than 2.00 to 1.00, the greater of one percentage point (1.0%) above Silicon Valley's prime rate, or seven percent (7.0%); or (ii) during such period that Sonic Foundry maintains an Adjusted Quick Ratio equal to or less than 2.00 to 1.00, the greater of one and one-half percent (1.5%) above Silicon Valley's prime rate, or seven and one-half percent (7.5%). Under the Amended Agreement, the term loan will continue to accrue interest at a per annum rate equal to the greater of (i) one percentage point (1.0%) above Silicon Valley's prime rate; or (ii) eight and three quarters percent (8.75%). Prior to the First Amendment, the maturity of both the term loan and the revolving line of credit was June 1, 2010. At the maturity date all outstanding borrowings and any unpaid interest thereon must be repaid, and all outstanding letters of credit must be cash collateralized. Principal on the term loan is to be repaid in thirty-six (36) monthly installments, and prior to the First Amendment, was to be repaid in full on May 1, 2010.

The Amended Loan Agreement contains certain financial covenants, including a covenant requiring the Companies to maintain certain of their depository, operating and securities accounts with Silicon Valley Bank, and a covenant relating to EBITDA (EBITDA Covenant); however, the EBITDA Covenant will not have to be satisfied provided that Sonic Foundry maintains an Adjusted Quick Ratio (as defined) greater than or equal to 1.75 to 1.00. The Amended Loan Agreement also contains certain other restrictive loan covenants, including covenants limiting the Companies' ability to dispose of assets, make acquisitions, be acquired, incur indebtedness, grant liens, make investments, pay dividends, and repurchase stock. At December 31, 2009 the Company was in compliance with all covenants in the Amended Loan Agreement, as amended by the First Amendment to the Amended and Restated Loan Agreement (First Amendment).

The Amended Loan Agreement contains events of default that include, among others, non-payment of principal or interest, inaccuracy of any representation or warranty, violation of covenants, bankruptcy and insolvency events, material judgments, cross defaults to certain other indebtedness, and material adverse changes. The occurrence of an event of default could result in the acceleration of the Companies' obligations under the Amended Loan Agreement.

Pursuant to the Amended Loan Agreement, the Company and its wholly-owned subsidiary pledged as collateral to the Bank substantially all non-intellectual property business assets, and entered into an Intellectual Property Security Agreement with respect to intellectual property assets.

On April 14, 2009, the Company executed the First Amendment with Silicon Valley Bank. The First Amendment, among other things, a) refinances the \$361,111 outstanding balance of the Term Loan with a new Term Loan 2 in the amount of \$1,000,000, due in 36 equal monthly installments of principal and interest; b) modifies the method of determining the requirement for a reserve under the Revolving Line for the balance of the term loan to require a reserve unless, for three (3) consecutive monthly periods, the ratio of EBITDA to Debt Service, in each case for the three (3) month period then ending is greater than or equal to 1.25 to 1.00; c) modifies the minimum requirements under the EBITDA covenant, but maintains the provision to override such covenant if the Company maintains a minimum Quick Ratio of 1.75 to 1.00; and d) extends the maturity date of the Revolving Line to October 1, 2011 and the Term Loan 2 to April 1, 2012. At December 31, 2009, a balance of \$798 thousand was remaining on the term loan and a balance of \$300 thousand was outstanding on the revolving line of credit. At December 31, 2009, there was \$871 thousand available under this credit facility for advances.

### **6. Income Taxes**

The Company is subject to taxation in the U.S. and various state jurisdictions. All of the Company's tax years are subject to examination by the U.S. and state tax authorities due to the carryforward of unutilized net operating losses.

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**

Beginning with an acquisition in fiscal year 2002, the Company has amortized Goodwill for tax purposes over a 15 year life. Goodwill is not amortized for book purposes. Annual impairment tests are performed for book purposes and the balance of goodwill is to be written down if impairment occurs. The impairment tests have not indicated any goodwill impairment.

The difference between the book and tax balance of Goodwill creates a Deferred Tax Liability and an annual tax expense. Because of the long term nature of the goodwill timing difference, tax planning strategies cannot be applied related to the Deferred Tax Liability. The balance of the Deferred Tax Liability at December 31, 2009 was \$1.31 million and at September 30, 2009 was \$1.25 million.

The Company's practice is to recognize interest and/or penalties related to income tax matters in income tax expense. The Company had no accruals for interest and penalties on the Company's Consolidated Balance Sheets at September 30, 2009 or December 31, 2009, and has not recognized any interest or penalties in the Consolidated Statements of Operations for either of the three month periods ended December 31, 2009 or 2008.

### **7. Liquidity**

In response to a history of recurring operating losses, the Company initiated cost reduction efforts in January 2008. These efforts achieved a 24% reduction in quarterly operating expenses during fiscal 2008. Continued efforts to control costs and improve revenues led to a 19% growth in revenues, an increase of three percentage points in gross margin and further reductions in operating costs in fiscal 2009. The Company anticipates further improvements in the gross margin rate and further reductions in operating expenses in fiscal 2010 and therefore believes its cash position is adequate to accomplish its business plan through at least the next twelve months, even if revenues in fiscal 2010 do not continue to improve. We may evaluate further operating or capital lease opportunities to finance equipment purchases in the future and anticipate utilizing the Company's revolving line of credit or other sources of debt to support working capital needs, if the Company deems it advisable to do so. We may also seek additional equity financing, or issue additional shares previously registered in our available shelf registration, although we currently have no plans to do so.

On April 14, 2009, the Company executed the First Amendment to the Amended and Restated Loan and Security Agreement (the "First Amendment") with Silicon Valley Bank which extended an existing credit facility in the form of a \$3,000,000 secured revolving line of credit and a \$1,000,000 term loan. While the Company anticipates limited use of the line of credit and that it will be in compliance with all provisions of the agreement, there can be no assurance that the existing Amended Loan Agreement will remain available to the Company nor that additional financing will be available or on terms acceptable to the Company.

### **8. Reverse Stock Split**

The Company completed a one-for-ten reverse split of its stock effective at the end of trading on November 16, 2009. The number of shares of Sonic Foundry common stock issued and outstanding have been reduced from approximately 36,069,000 shares to approximately 3,606,900 shares post-split, without accounting for the payout on fractional shares. This reverse stock split has been reflected in the share and per share data presented throughout this report.

### **9. NASDAQ Notification of Failure to Satisfy a Continued Listing Rule**

In March 2008, our common stock failed to maintain a minimum bid price of \$1.00 for at least 10 consecutive days, which caused our stock price to fail to meet one of the minimum standards required by the NASDAQ Stock Market for continued listing as a NASDAQ Global Market security. On March 10, 2008 we received a letter from NASDAQ indicating that we need to regain compliance with the minimum bid price requirement by September 8, 2008 in order to remain on the NASDAQ Global Market. On September 9, 2008 we were notified by NASDAQ that we had failed to regain compliance with the minimum bid price during the 180 days provided and our securities were therefore subject to delisting from the NASDAQ Global Market. In response, we applied for and were notified on September 12, 2008 by NASDAQ that NASDAQ approved our request to transfer the listing of our shares to the NASDAQ Capital Market. Transfer to the NASDAQ Capital Market and compliance with its initial listing standards afforded an additional 180 day period for our stock to attain the minimum \$1.00 bid price for at least 10 consecutive business days until March 9, 2009. We received notice from NASDAQ on October 22, 2008, December 23, 2008 and March 24, 2009 that NASDAQ had determined to extend the suspension of the minimum bid price for additional 90 day periods. On July 14, 2009, we received notice from NASDAQ that enforcement of the minimum bid price requirement would be reinstated on August 3, 2009. The Company had 141 calendar days remaining in its bid price compliance period when suspension began, extending the period in which to regain compliance to December 21, 2009.



**Table of Contents**

On November 2, 2009 the Company notified NASDAQ that it intended to execute a reverse split of its stock in the ratio of one for ten, effective November 16, 2009. On December 2, 2009, the Company received notice from NASDAQ that the Company had regained compliance with the minimum bid requirement and the matter was closed.

## **Table of Contents**

### **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, 2009. 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.

Uncertainty about current global economic conditions poses a risk as businesses, educational institutions and state governments are likely to postpone spending in response to tighter credit, negative financial news and/or declines in income or asset values. Most of our customers and potential customers are public colleges, universities, schools and other education providers who depend substantially on government funding. Many state governments are under substantial budget constraints and will likely reduce spending for education providers, without Federal government support. Proposed federal government support for education may not be approved or, if approved, may not succeed in eliminating reductions in spending for our products and services.

Other factors that may impact actual results include: our ability to effectively integrate acquired businesses, length of time necessary to close on sales leads to multi-unit purchasers, our ability to service existing accounts, 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 September 2006, the FASB issued guidance, which provided enhanced guidance for using fair value to measure assets and liabilities. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The Standard does not expand the use of fair value in any new circumstances. The adoption of this standard on October 1, 2008 for financial assets and liabilities did not have a material effect on the Company's results of operations or financial position. In February 2008, the FASB issued additional guidance which deferred the effective date for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (that is, at least annually), to fiscal years beginning after November 15, 2008. Early adoption is permitted. The adoption of this standard related to non financial assets and liabilities on October 1, 2009 did not have a material effect on the Company's results of operations or financial position other than requiring additional disclosures for those items where non-recurring fair valuing of certain assets is performed.

**Table of Contents**

In April 2009, the FASB issued guidance concerning interim disclosures about fair value of financial instruments requiring publicly traded companies to provide disclosure about the fair value of financial instruments whenever interim summarized financial information is reported. Previously, disclosures about the fair value of financial instruments were only required on an annual basis. Disclosure shall include the method(s) and significant assumptions used to estimate the fair value of financial instruments and shall describe changes in method(s) and significant assumptions, if any, during the period. This guidance was effective for interim and annual periods ending after June 15, 2009, and, as such, the Company began including this disclosure with its third quarter 2009 financial statements.

In October 2009, the FASB issued Accounting Standards Update 2009-13, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements* ( ASU 2009-13 ) and ASU 2009-14, *Software (Topic 985) Certain Revenue Arrangements That Include Software Elements* ( ASU 2009-14 ). ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: (i) vendor-specific objective evidence, or VSOE , or (ii) third-party evidence, or TPE , before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. These new updates are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. An entity may elect retrospective application to all revenue arrangements for all periods presented. Entities must adopt the amendments resulting from both of these ASUs in the same period using the same transition method, where applicable. The Company is currently evaluating the impact that the adoption of these ASUs will have on our consolidated financial statements.

**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, allowance for doubtful accounts and reserves;

Impairment of long-lived assets;

Valuation allowance for net deferred tax assets; and

Accounting for stock-based compensation.

*Revenue Recognition, Allowance for Doubtful Accounts and Reserves*

**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 collectability 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 exchange or repair pursuant to a warranty or stock rotation. 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.

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## **Table of Contents**

### 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 recorders and Mediasite related products such as our server software.

### Services

We sell support contracts to our 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 distribution partners, software upgrades on a when and if available basis, advance hardware replacement and an extension of the standard hardware warranty from 90 days to one year. The manufacturers we contract with to build the units provide a limited one-year warranty on the hardware. We also sell installation, training, event webcasting, and customer content hosting services. Revenue for those services is recognized when performed in the case of installation, training and event webcasting services and is recognized ratably over the contract period for content hosting services. Service amounts invoiced to customers in excess of revenue recognized are recorded as deferred revenue until the revenue recognition criteria are met.

### Revenue Arrangements that Include Multiple Elements

Revenue for transactions that include multiple elements such as hardware, software, installation, training, and post customer support is allocated to each element based on vendor-specific objective evidence of the fair value *VSOE* in accordance with FASB ASC-985-605. Revenue is recognized for each element when the revenue recognition criteria have been met for that element. *VSOE* is based on the price charged when the element is sold separately. If *VSOE* of fair value does not exist for all elements in a multiple element arrangement, 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.

### Reserves

We record reserves for stock rotations, price adjustments, rebates, and sales incentives to reduce revenue and accounts receivable for these and other credits we may grant to customers. Such reserves are recorded at the time of sale and are calculated based on historical information (such as rates of product stock rotations) and the specific terms of sales programs, taking into account any other known information about likely customer behavior. If actual customer behavior differs from our expectations, additional reserves may be required. Also, if we determine that we can no longer accurately estimate amounts for stock rotations and sales incentives, we would not be able to recognize revenue until the customers exercise their rights, or such rights lapse, whichever is later.

### Credit Evaluation and Allowance for Doubtful Accounts

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.

### *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.

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 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.



**Table of Contents**

We evaluate all of our long-lived assets, including intangible assets other than goodwill, for impairment in accordance with the provisions of FASB ASC-360-10. We evaluate all of our long-lived assets and intangible assets, including intangible assets other than goodwill, for impairment. Long-lived assets and intangible assets other than goodwill are evaluated for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on expected undiscounted cash flows attributable to that asset. Should events indicate that any of our long-lived assets are impaired; the amount of such impairment will be measured as the difference between the carrying value and the fair value of the impaired asset and recorded in earnings during the period of such impairment.

*Valuation allowance for net deferred tax assets*

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

*Accounting for stock-based compensation*

Upon the adoption of FASB ASC-718, 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. Forfeitures are based on actual behavior patterns.

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

Revenue from our business include the sales of Mediasite recorders and server software products and related services contracts, such as customer support, installation, training, content hosting and event services sold separately. 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.

*Q1-2010 compared to Q1-2009*

Revenue in Q1-2010 increased \$493 thousand, or 12% from Q1-2009 revenue of \$4.0 million to \$4.5 million. Revenue consisted of the following:

Product revenue from sale of Mediasite capture units

	Q1-2010	Q1-2009
Units sold	195	183
Rack to mobile ratio	2.1 to 1	2.2 to 1
Average sales price, excluding service (000 \$)	\$ 10.8	\$ 10.0

Services revenue represents the portion of fees charged for Mediasite SmartServe customer support 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 \$2.2 million in Q1-2009 to \$2.5 million in Q1-2010 primarily due to an increase in support contracts on new Mediasite capture units and renewals of support contracts entered into in prior years. At December 31, 2009 \$5.0 million of

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unrecognized support and service revenue remained in unearned revenues, of which we expect to realize approximately \$2.0 million in the upcoming quarter.

## **Table of Contents**

Other revenue relates to freight charges billed separately to our customers.

### **Gross Margin**

Total gross margin for Q1-2010 was \$3.5 million for a gross margin percentage of 77% compared to Q1-2009 of \$3.1 million or 78%. Gross margin decreased slightly due to an increase in costs of direct and outsourced labor. The significant components of cost of revenue include:

Material and freight costs for the Mediasite recorders. Costs for Q1-2010 Mediasite recorder hardware and other costs totaled \$592 thousand, along with \$48 thousand of freight costs, and \$190 thousand of labor and allocated costs compared to Q1-2009 Mediasite recorder costs of \$592 thousand for hardware, \$53 thousand for freight and \$121 thousand labor and allocated costs.

Services costs. Staff wages and other costs allocated to cost of service revenues were \$190 thousand in Q1-2010 and \$125 thousand in Q1-2009, resulting in gross margin on services of 93% in Q1-2010 and 94% in Q1-2009.

### **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 or entrance into new markets, or participation in major tradeshow.

#### ***Q1-2010 compared to Q1-2009***

Selling and marketing expenses decreased \$445 thousand or 17% from \$2.7 million in Q1-2009 to \$2.2 million in Q1-2010 resulting from:

Q1-2009 salaries, incentive compensation and benefits exceeded Q1-2010 by \$306 thousand due to the implementation of a new incentive compensation plan in 2010 as well as severance paid out in Q1-2009. Our sales and marketing staff remained at 58 at both December 31, 2009 and 2008.

Q1-2010 stock compensation decreased \$183 thousand primarily due to prior expense reversing in Q1-2010 due to forfeitures.

Q1-2009 advertising and tradeshow expenses decreased \$76 thousand as a result of certain corporate and other marketing activities that were reduced or eliminated.

We anticipate selling and marketing headcount to remain at approximately this level for the remainder of the fiscal year.

#### **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.

#### ***Q1-2010 compared to Q1-2009***

G&A expenses increased \$20 thousand or 3% over the prior period from \$783 thousand in Q1-2009 to \$803 thousand in Q1-2010. Increased facilities expense of \$14 thousand and benefits expense of \$11 thousand contributed to the overall increase.



## **Table of Contents**

As of December 31, 2009 we had 6 employees in G&A compared to 8 as of December 31, 2008. We anticipate G&A headcount to remain at this level for the remainder of the fiscal year.

### **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.

#### *Q1-2010 compared to Q1-2009*

Product development expenses decreased \$192 thousand, or 21% from \$903 thousand in Q1-2009 to \$711 thousand in Q1-2010. Some significant differences between the periods include:

Decreased compensation and benefits of \$50 thousand due to no bonus expense in Q1-2010.

Decreased stock compensation expense of \$76 thousand primarily due to prior expense reversing in Q1-2010 due to forfeitures.

Decreased facilities expense allocated to product development of \$64 thousand.

As of December 31, 2009 and 2008 we had 24 employees, excluding interns, in Product Development. We anticipate product development headcount to remain flat during the remainder of fiscal 2010. We do not anticipate that any fiscal 2010 software development efforts will qualify for capitalization.

### **Other Income**

Other income is primarily interest income from overnight investment vehicles.

### **Provisions Related to Income Taxes**

On the September 30, 2009, 10-K filing, the Company recorded a non-cash deferred tax liability related to goodwill acquired in 2001 and made corresponding revisions to earlier results. The net impact was to record a \$142 thousand non-cash provision for taxes and an increase to a long-term deferred tax liability of \$142 thousand in fiscal 2009 and to record a \$256 thousand non-cash provision for taxes in fiscal 2008 as well as the accumulated impact of prior period amortization of goodwill. This liability had historically been presented net of deferred tax assets and associated valuation allowances. Management determined that due to the nature of the deferred tax liability and future growth of such non-cash liability it was more prudent to present separately. Q1-2009 numbers have been revised to match this presentation.

### **Liquidity and Capital Resources**

Cash used in operating activities was \$127 thousand in Q1-2010 compared to cash provided by operating activities in Q1-2009 of \$9 thousand. Cash used in 2010 was impacted by a decrease in the net loss of \$956 thousand from \$1.3 million to \$320 thousand and partially offset by changes in working capital. Working capital changes included the positive effects of reductions in accounts receivable of \$225 thousand, reduction in inventory of \$133 thousand and reductions in other current assets of \$194 thousand. These were offset by the negative effects of a \$228 thousand decrease in accounts payable and accrued liabilities and a \$231 thousand decrease in unearned revenue. Q1-2009 had more significant changes in working capital components with a \$1.3 million decrease in accounts receivable.

Cash used in investing activities was \$20 thousand in Q1-2010 compared to a use of \$131 thousand in Q1-2009 for the purchase of property and equipment.

Cash used in financing activities was \$85 thousand in Q1-2010 compared to use of \$82 thousand in Q1-2009. These amounts are comprised of cash used for payments on capital leases and note payable.



**Table of Contents**

In response to a history of recurring operating losses, the Company initiated cost reduction efforts in January 2008. These efforts achieved a 24% reduction in quarterly operating expenses during fiscal 2008. Continued efforts to control costs and improve revenues led to a 19% growth in revenues, an increase of three percentage points in gross margin and further reductions in operating costs in fiscal 2009. The Company anticipates further improvements in the gross margin rate and further reductions in operating expenses in fiscal 2010 and therefore believes its cash position is adequate to accomplish its business plan through at least the next twelve months, even if revenues in fiscal 2010 do not continue to improve. We may evaluate further operating or capital lease opportunities to finance equipment purchases in the future and anticipate utilizing the Company's revolving line of credit or other sources of debt to support working capital needs, if the Company deems it advisable to do so. We may also seek additional equity financing, or issue additional shares previously registered in our available shelf registration, although we currently have no plans to do so.

On April 14, 2009, the Company executed the First Amendment to the Amended and Restated Loan and Security Agreement (the "First Amendment") with Silicon Valley Bank which extended an existing credit facility in the form of a \$3,000,000 secured revolving line of credit and a \$1,000,000 term loan. While the Company anticipates limited use of the line of credit and that it will be in compliance with all provisions of the agreement, there can be no assurance that the existing Amended Loan Agreement will remain available to the Company nor that additional financing will be available or on terms acceptable to the Company.

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. Obligations of approximately \$589 thousand, all of which we expect to purchase over the next fiscal quarter, remain. This commitment is not recorded on the Company's Consolidated Balance Sheet. The Company had approximately \$1.8 million of purchase commitments as of December 31, 2008.

**Table of Contents**

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

**Derivative Financial Instruments**

We are not party to any derivative financial instruments or other financial instruments for which the fair value disclosure would be required under FASB ASC-815-10. Our cash equivalents consist of overnight investments in money market funds that are carried at fair value. Accordingly, we believe that the market risk of such investments is minimal.

**Interest Rate Risk**

Our cash equivalents are subject to interest rate fluctuations, however, we believe this risk is minimal 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, 2009, 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, and that material information relating to the Company is accumulated and communicated to management, including our principal executive officer and our principal financial officer, as appropriate to allow timely decisions regarding required disclosures.

**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(b) 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.



**Table of Contents**

**PART II**

**OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

None

**ITEM 1A. RISK FACTORS**

There have been no material changes in our risk factors from those disclosed in our Form 10-K for the fiscal year ended September 30, 2009 filed with the SEC.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

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

None

**ITEM 5. OTHER INFORMATION**

None

**Table of Contents**

**ITEM 6. EXHIBITS**

NUMBER	DESCRIPTION
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. 3.1 to Form 8-K filed on December 19, 2007, 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*	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.
10.3*	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.
10.4*	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.
10.5	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.
10.6	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.
10.7	Intellectual Property Security Agreement dated May 2, 2007, between Sonic Foundry, Inc. and Silicon Valley Bank filed as Exhibit 10.2 to Form 8-K on May 7, 2007, and hereby incorporated by reference.
10.8	Intellectual Property Security Agreement dated May 2, 2007, between Sonic Foundry Media Systems, Inc. and Silicon Valley Bank filed as Exhibit 10.3 to Form 8-K on May 7, 2007, and hereby incorporated by reference.
10.9*	Employment Agreement dated October 31, 2007 between Sonic Foundry, Inc. and Kenneth A. Minor, filed as Exhibit 10.1 to Form 8-K filed on November 2, 2007, and hereby incorporated by reference.
10.10	Amended and Restated Loan and Security Agreement dated June 16, 2008 and entered into as of June 16, 2008 among registrant, Sonic Foundry Media Services, Inc. and Silicon Valley Bank, filed as exhibit 10.1 to Form 8-K filed on June 20, 2008, and hereby incorporated by reference.
10.11*	Employment Agreement dated August 4, 2008 between Sonic Foundry, Inc. and Robert M. Lipps, filed as Exhibit 10.1 to Form 8-K filed on August 6, 2008, and hereby incorporated by reference.

**Table of Contents**

- 10.12 First Amendment to the Amended and Restated Loan and Security Agreement executed as of April 14, 2009 and effective as of April 1, 2009, among registrant, Sonic Foundry Media Services, Inc. and Silicon Valley Bank, filed as exhibit 10.1 to Form 8-K filed on April 15, 2009, and hereby incorporated by reference.
- 10.13\* Registrant's 2008 Non-Employee Directors' Stock Option Plan filed as Exhibit B to Form 14A filed on January 28, 2008, and hereby incorporated by reference
- 10.14\* Registrant's 2008 Employee Stock Purchase Plan filed as Exhibit C to Form 14A filed on January 28, 2008, and hereby incorporated by reference
- 10.15\* Registrant's 2009 Stock Incentive Plan filed as Exhibit A to Form 14A filed on January 28, 2009, 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

**Table of Contents**

***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)

January 29, 2010

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

January 29, 2010

By: /s/ KENNETH A. MINOR  
**Kenneth A. Minor**  
**Chief Financial Officer, Chief Accounting Officer and Secretary**