

SONIC FOUNDRY INC  
Form 10-Q  
February 06, 2009  
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**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, 2008

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                          | Outstanding                    |
|--------------------------------|--------------------------------|
| Common Stock, \$0.01 par value | February 5, 2009<br>35,627,670 |

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

|   | <b>December 31,<br/>2008</b> | <b>September 30,<br/>2008</b> |
|---|------------------------------|-------------------------------|
| <b>Assets</b>   |                              |                               |
| Current assets:   |                              |                               |
| Cash and cash equivalents   | \$ 3,356                     | \$ 3,560                      |
| Accounts receivable, net of allowance of \$120 and \$150  | 2,607                        | 3,864                         |
| Inventories   | 318                          | 330                           |
| Prepaid expenses and other current assets   | 430                          | 429                           |
| <b>Total current assets</b>   | <b>6,711</b>                 | <b>8,183</b>                  |
| Property and equipment:   |                              |                               |
| Leasehold improvements  | 980                          | 980                           |
| Computer equipment  | 2,607                        | 2,476                         |
| Furniture and fixtures  | 461                          | 461                           |
| <b>Total property and equipment</b>   | <b>4,048</b>                 | <b>3,917</b>                  |
| Less accumulated depreciation   | 2,379                        | 2,223                         |
| <b>Net property and equipment</b>   | <b>1,669</b>                 | <b>1,694</b>                  |
| Other assets:   |                              |                               |
| Goodwill  | 7,576                        | 7,576                         |
| Other intangibles, net of amortization of \$21 and \$19   | 19                           | 21                            |
| <b>Total assets</b>   | <b>\$ 15,975</b>             | <b>\$ 17,474</b>              |
| <b>Liabilities and stockholders equity</b>  |                              |                               |
| Current liabilities:  |                              |                               |
| Accounts payable  | \$ 990                       | \$ 1,256                      |
| Accrued liabilities   | 1,075                        | 1,113                         |
| Unearned revenue  | 4,604                        | 4,661                         |
| Current portion of notes payable  | 333                          | 333                           |
| Current portion of capital lease obligations  | 43                           | 46                            |
| <b>Total current liabilities</b>  | <b>7,045</b>                 | <b>7,409</b>                  |
| Long-term portion of notes payable  | 139                          | 223                           |
| Long-term portion of capital lease obligations  | 14                           | 24                            |
| Other liabilities   | 234                          | 255                           |
| <b>Total liabilities</b>  | <b>7,432</b>                 | <b>7,911</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 | 357                          | 357                           |

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Common stock, \$.01 par value, authorized 100,000,000 shares; 35,754,837 and 35,728,837 shares issued and 35,627,670 and 35,601,670 shares outstanding

|   |                  |                  |
|---|------------------|------------------|
| Additional paid-in capital                        | 184,424          | 184,204          |
| Accumulated deficit                               | (176,043)        | (174,803)        |
| Receivable for common stock issued                | (26)             | (26)             |
| Treasury stock, at cost, 127,167 shares           | (169)            | (169)            |
| <b>Total stockholders' equity</b>                 | <b>8,543</b>     | <b>9,563</b>     |
| <b>Total liabilities and stockholders' equity</b> | <b>\$ 15,975</b> | <b>\$ 17,474</b> |

See accompanying notes

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

(in thousands, except for share and per share data)

(Unaudited)

|                                       | Three Months Ended<br>December 31, |                   |
|---------------------------------------|------------------------------------|-------------------|
|                                       | 2008                               | 2007              |
| <b>Revenue:</b>                       |                                    |                   |
| Product                               | \$ 1,744                           | \$ 942            |
| Services                              | 2,236                              | 1,558             |
| Other                                 | 29                                 | 20                |
| <b>Total revenue</b>                  | <b>4,009</b>                       | <b>2,520</b>      |
| <b>Cost of revenue:</b>               |                                    |                   |
| Product                               | 766                                | 510               |
| Services                              | 125                                | 112               |
| <b>Total cost of revenue</b>          | <b>891</b>                         | <b>622</b>        |
| <b>Gross margin</b>                   | <b>3,118</b>                       | <b>1,898</b>      |
| <b>Operating expenses:</b>            |                                    |                   |
| Selling and marketing                 | 2,663                              | 3,546             |
| General and administrative            | 783                                | 978               |
| Product development                   | 903                                | 946               |
| <b>Total operating</b>                | <b>4,349</b>                       | <b>5,470</b>      |
| <b>Loss from operations</b>           | <b>(1,231)</b>                     | <b>(3,572)</b>    |
| Other income (expense), net           | (9)                                | 32                |
| <b>Net loss</b>                       | <b>\$ (1,240)</b>                  | <b>\$ (3,540)</b> |
| <b>Net loss per common share:</b>     |                                    |                   |
| basic and diluted                     | \$ (0.03)                          | \$ (0.10)         |
| <b>Weighted average common shares</b> |                                    |                   |
| basic and diluted                     | 35,607,887                         | 35,561,814        |

See accompanying notes

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

|   | <b>Three months ended<br/>December 31,</b> |             |
|---|--|-------------|
|   | <b>2008</b>                                | <b>2007</b> |
| <b>Operating activities</b>   |  |             |
| Net loss  | \$ (1,240)                                 | \$ (3,540)  |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |  |             |
| Amortization of other intangibles   | 2  | 3           |
| Depreciation and amortization of property and equipment                                   | 156  | 167         |
| Loss on sale of fixed assets  |  | 5           |
| Other non-cash items  | (2)  | 48          |
| Share-based compensation expense related to stock warrants and options                    | 205  | 317         |
| Provision for doubtful accounts   | (30)                                       | (80)        |
| Changes in operating assets and liabilities:  |  |             |
| Accounts receivable   | 1,287                                      | 2,735       |
| Inventories   | 12   | (460)       |
| Prepaid expenses and other current assets   | (1)  | 167         |
| Accounts payable and accrued liabilities  | (304)                                      | (985)       |
| Other long-term liabilities   | (21)                                       | (23)        |
| Unearned revenue  | (55)                                       | (75)        |
| Net cash provided by (used in) operating activities                                       | 9  | (1,721)     |
| <b>Investing activities</b>   |  |             |
| Purchases of property and equipment   | (131)                                      | (37)        |
| Net cash used in investing activities   | (131)                                      | (37)        |
| <b>Financing activities</b>   |  |             |
| Payments on notes payable   | (84)                                       | (83)        |
| Proceeds from exercise of common stock options  | 15   | 15          |
| Payments on capital lease obligations   | (13)                                       | (15)        |
| Net cash used in financing activities   | (82)                                       | (83)        |
| Net decrease in cash  | (204)                                      | (1,841)     |
| Cash and cash equivalents at beginning of period  | 3,560                                      | 8,008       |
| Cash and cash equivalents at end of period  | \$ 3,356                                   | \$ 6,167    |

See accompanying notes

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**Sonic Foundry, Inc.**

**Notes to Consolidated Financial Statements**

**December 31, 2008**

**(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 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, 2008. In the opinion of management, all adjustments (consisting only of adjustments of a normal and recurring nature) considered necessary for a fair presentation of the results of operations have been included. Operating results for the three month period ended December 31, 2008 are not necessarily indicative of the results that might be expected for the year ending September 30, 2009.

***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 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 server software revenue.

**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.

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### 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 Statement of Position ( SOP ) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2. 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.

For revenue arrangements with multiple elements outside the scope of SOP 97-2, the Company accounts for the arrangements in accordance with Emerging Issues Task Force ( EITF ) Issue 00-21, Revenue Arrangements with Multiple Elements, and allocates the arrangement s fees into separate units of accounting based on fair value. The Company supports fair value of the elements based upon the prices the Company charges when it sells similar elements separately.

### 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 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):

|                            | 12/31/08 | 9/30/08 |
|----------------------------|----------|---------|
| Raw materials and supplies | \$ 10    | \$ 10   |
| Finished goods             | 308      | 320     |
|                            | \$ 318   | \$ 330  |

***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. The directors stock option plan expired in October 2007. In March 2008, shareholders approved adoption of the 2008 Sonic Foundry Non-Employee Directors Stock Option Plan ( 2008 Directors Plan ). The 2008 Directors Plan provides for the issuance of up to 500,000 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 shareholders, will be granted options to purchase 20 thousand shares of common stock under the 2008 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 is recognized in earnings on a straight-line basis over the requisite service period. There were no capitalized stock-based compensation costs at December 31, 2008.

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.

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

| Method                  | Three months ended<br>December 31, |                      |
|-------------------------|------------------------------------|----------------------|
|                         | 2008                               | 2007                 |
| Expected life (years)   | Lattice<br>5.9 years               | Lattice<br>6.0 years |
| Risk-free interest rate | 1.63%                              | 3.43%                |
| Expected volatility     | 80.21%                             | 63.08%               |
| Expected dividend yield | 0%                                 | 0%                   |

A summary of option activity as of December 31, 2008 and changes during the three months then ended is presented below:

|                                  | Options   | Weighted-<br>Average<br>Exercise Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Period | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|-----------|--|--|---------------------------------|
| Outstanding at October 1, 2008   | 6,240,477 | \$ 2.05                                | 5.7  | \$ 37,722                       |
| Granted                          | 1,039,500 | 0.53                                   | 9.9  |                                 |
| Exercised                        | (26,000)  | 0.53                                   | 9.9  |                                 |
| Forfeited                        | (102,742) | (1.97)                                 | (5.6)  |                                 |
| Outstanding at December 31, 2008 | 7,151,235 | 1.83                                   | 6.0  | 2,425                           |
| Exercisable at December 31, 2008 | 4,977,185 | \$ 2.17                                | 4.6  | \$ 2,425                        |

A summary of the status of the Company's non-vested shares and changes during the three month periods ended December 31, 2008 and 2007 are presented below:

| Non-vested Shares          | 2008      |   | 2007      |   |
|----------------------------|-----------|---|-----------|---|
|                            | Shares    | Weighted-Average<br>Grant Date<br>Fair<br>Value | Shares    | Weighted-Average<br>Grant Date<br>Fair<br>Value |
| Non-vested at October 1,   | 1,972,448 | \$ 0.77   | 1,073,194 | \$ 1.41   |
| Granted                    | 1,039,500 | 0.29  | 1,178,250 | 0.88  |
| Vested                     | (777,562) | 0.58  | (334,330) | 1.11  |
| Forfeited                  | (60,336)  | 0.88  | (41,666)  | 1.16  |
| Non-vested at December 31, | 2,174,050 | \$ 0.61   | 1,875,455 | \$ 1.13   |

The weighted average grant date fair value of options granted during the three months ended December 31, 2008 was \$0.29. As of December 31, 2008, there was \$593 thousand of total unrecognized compensation cost related to non-vested share-based compensation, net of \$263 thousand of estimated forfeitures. The cost is expected to be recognized over a weighted-average remaining life of 1.6 years.

Stock-based compensation recorded in the three month period ended December 31, 2008 of \$205 thousand was allocated \$132 thousand to selling and marketing expenses, \$18 thousand to general and administrative expenses and \$55 thousand to product development expenses. Cash received from option exercises under all stock option plans for the three month periods ended December 31, 2008 and 2007 was \$15 thousand. There were no tax benefits realized for tax deductions from option exercises in either of the three month periods ended December 31, 2008 and 2007. The Company currently expects to satisfy share-based awards with registered shares available to be issued.

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The Company also maintains an Employee Stock Purchase Plan (Purchase Plan) under which an aggregate of 500,000 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

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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 10,000 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 142,280 shares purchased by employees for the six month offering ended December 31, 2008. These shares were issued in January, 2009. The company recorded stock compensation expense of \$31 thousand during the three months ended December 31, 2008.

**Per share computation**

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

|   | <b>Three Months Ended<br/>December 31,</b> |             |
|---|--|-------------|
|   | <b>2008</b>                                | <b>2007</b> |
| <b>Denominator</b>  |  |             |
| Denominator for basic and diluted loss per share — weighted average common shares   | 35,607,887                                 | 35,561,814  |
| Securities outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive: |  |             |
| Options and warrants  | 7,702,643                                  | 6,210,146   |

**New Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ), which provides 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. In February 2008, the FASB issued FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157, which defers 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 is not expected to have a material effect on the Company's results of operations or financial position.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ) including an Amendment of SFAS 115, which permits but does not require the Company to measure financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations ( SFAS 141(R) ), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. SFAS 141(R) is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

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In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements ( SFAS 160 ) an amendment of ARB No. 51. SFAS 160 amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Among other requirements, this statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In April 2008, the FASB issued Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets ( FSP 142-3 ). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS 142. FSP 142-3 is effective for fiscal years beginning after December 15, 2008. Early adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In May 2008, the FASB issued Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles ( SFAS 162 ). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of non-governmental entities that are presented in conformity with GAAP. SFAS 162 directs the GAAP hierarchy to the entity, not the independent auditors, as the entity is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. SFAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to remove the GAAP hierarchy from the auditing standards. SFAS 162 is not expected to have a material impact on our results of operations or financial position.

In November 2008, the FASB issued EITF 08-6, Equity Method Investment Accounting Considerations ( EITF 08-6 ). EITF 08-6 clarifies that the initial carrying value of an equity method investment should be determined in accordance with SFAS No. 141(R). Other-than-temporary impairment of an equity method investment should be recognized in accordance with FSP No. APB 18-1, Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence. EITF 08-6 is effective on a prospective basis in fiscal years beginning on or after December 15, 2008 and interim periods within those fiscal years. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

**2. Related Party Transactions**

During each of the three month periods ended December 31, 2008 and 2007, the Company incurred fees of \$63 thousand 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 \$20 and \$92 thousand for the periods ended December 31, 2008 and 2007 respectively, to the same law firm.

During the three month periods ended December 31, 2008 and 2007, the Company recorded Mediasite product and customer support billings of \$152 and \$111 thousand, respectively, to MSKK, a Japanese reseller in which the Company has an equity interest.

As of December 31, 2008 and 2007, the Company had a loan outstanding to an executive totaling \$26 thousand. This loan is secured by company stock.

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**3. Purchase Commitments**

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. Obligations of approximately \$1.8 million, of which we expect to purchase approximately \$700 thousand over the next fiscal quarter, remain. This commitment is not recorded on the Company's Balance Sheet. The Company had \$459 thousand of purchase commitments as of December 31, 2007.

**4. 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 equal to the balance of the term loan when EBITDA, as defined, is less than \$200,000 during the preceding six month period. At December 31, 2008, there was \$866 thousand available under this credit facility for advances. The revolving line of credit will accrue 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%). The maturity of both the term loan and the revolving line of credit is June 1, 2010, at which time 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) equal monthly installments, and will be repaid in full on May 1, 2010. At December 31, 2008, a balance of \$472 thousand was remaining on the term loan with no outstanding balance on the revolving line of credit.

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. At December 31, 2008 the Company was in compliance with all covenants in the Amended Loan Agreement. 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.

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.

**5. Income Taxes**

In June 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation (FIN 48) No. 48, Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes, and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

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The Company adopted the provisions of FIN 48 on October 1, 2007. The total amount of unrecognized tax benefits as of the date of adoption was not significant. As such, there are no unrecognized tax benefits included in the balance sheet that would, if recognized, affect the effective tax rate.

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 Balance Sheets at September 30, 2008 or December 31, 2008, and has not recognized any interest or penalties in the Statement of Operations for the three month period ended December 31, 2008.

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.

## **6. Liquidity**

The Company has incurred losses from operations in each of the last three fiscal years. In response to the 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. The Company anticipates operating expenses to remain at or near these reduced levels in fiscal 2009. The Company anticipates growth in billings in fiscal 2009 and believes its cash position is adequate to accomplish its business plan through at least the next twelve months even if billings remain unchanged, and the Company has no plans to seek additional equity financing or to issue additional shares previously registered in its available shelf registration. We may evaluate further operating or capital lease opportunities to finance equipment purchases in the future and may utilize the Company's revolving line of credit or request an increase to the term loan to support working capital needs, if the Company deems it advisable to do so.

On June 16, 2008, the Company 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. 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 on terms acceptable to the Company.

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

On March 10, 2008, the Company received notice from the NASDAQ Listing Qualifications Department (the "Staff") stating that for 30 consecutive business days the bid price for the Company's common stock has closed below the minimum \$1.00 per share requirement for continued inclusion under Marketplace Rule 4450(a)(5).

The letter, dated March 10, 2008, indicated that in accordance with Marketplace Rule 4450(e)(2), the Company would be provided 180 calendar days, or until September 8, 2008, to regain compliance with the Rule 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 affords 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.

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We received notice from NASDAQ on October 22, 2008 that, in response to extraordinary market conditions, NASDAQ was suspending enforcement of the minimum bid price requirement of \$1 per share for 90 days. We received an additional notice on December 23, 2008 that NASDAQ had determined to extend the suspension of the minimum bid price for an additional 90 days. Without further suspensions of the rule, we would need to regain compliance with the minimum bid price in September 2009.

We may not regain compliance with the minimum \$1.00 bid price requirement during the additional period and our stock may be delisted, which may have a material adverse effect on the price of our common stock and the levels of liquidity currently available to our stockholders. Delisting would also make it more difficult for us to raise capital in the future and may impact customer confidence. If our common stock is removed from the NASDAQ Capital Market, an investor could find it more difficult to dispose of, or to obtain accurate quotations as to the market value of, our common shares. Additionally, our stock may then be subject to penny stock regulations.

The Company intends to actively monitor the bid price for its common stock between now and September, 2009, and consider implementation of various options available to the Company if its common stock does not trade at a level that is likely to regain compliance.

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

#### **Risks and Uncertainties**

The following discussion of the consolidated financial position and results of operations of the Company should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this form 10-Q and the Company's annual report filed on form 10-K for the fiscal year ended September 30, 2008. 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 SFAS No. 157, Fair Value Measurements ( SFAS 157 ), which provides 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. In February 2008, the FASB issued FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157, which defers 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 is not expected to have a material effect on the Company's results of operations or financial position.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ) including an Amendment of SFAS 115, which permits but does not require the Company to measure financial instruments and

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certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations ( SFAS 141(R) ), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. SFAS 141(R) is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements ( SFAS 160 ) an amendment of ARB No. 51. SFAS 160 amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Among other requirements, this statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In April 2008, the FASB issued Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets ( FSP 142-3 ). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS 142. FSP 142-3 is effective for fiscal years beginning after December 15, 2008. Early adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

In May 2008, the FASB issued Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles ( SFAS 162 ). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of non-governmental entities that are presented in conformity with GAAP. SFAS 162 directs the GAAP hierarchy to the entity, not the independent auditors, as the entity is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. SFAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to remove the GAAP hierarchy from the auditing standards. SFAS 162 is not expected to have a material impact on our results of operations or financial position.

In November 2008, the FASB issued EITF 08-6, Equity Method Investment Accounting Considerations ( EITF 08-6 ). EITF 08-6 clarifies that the initial carrying value of an equity method investment should be determined in accordance with SFAS No. 141(R). Other-than-temporary impairment of an equity method investment should be recognized in accordance with FSP No. APB 18-1, Accounting by an Investor for Its Proportionate Share of Accumulated Other Comprehensive Income of an Investee Accounted for under the Equity Method in Accordance with APB Opinion No. 18 upon a Loss of Significant Influence. EITF 08-6 is effective on a prospective basis in fiscal years beginning on or after December 15, 2008 and interim periods within those fiscal years, and will be adopted by us in the first quarter of fiscal year 2010. The adoption of this standard is not expected to have a material effect on the Company's results of operations or financial position.

### **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;

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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 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 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 recorders and Mediasite related products such as server software revenue.

### 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.

### 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 Statement of Position (SOP) 97-2, Software Revenue Recognition, and SOP 98-9, Modification of SOP 97-2. 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.

For revenue arrangements with multiple elements outside the scope of SOP 97-2, the Company accounts for the arrangements in accordance with Emerging Issues Task Force (EITF) Issue 00-21, Revenue Arrangements with Multiple Elements, and allocates the arrangement's fees into separate units of accounting based on fair value. The Company supports fair value of the elements based upon the prices the Company charges when it sells similar elements separately.

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### 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.

### 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.

### 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.

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

### *Valuation allowance for net deferred tax assets*

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

### *Accounting for stock-based compensation*

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. 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



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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**

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.

***Q1-2009 compared to Q1-2008***

Revenue in Q1-2009 increased \$1.5 million, or 59% from Q1-2008 revenue of \$2.5 million to \$4.0 million. Q1-2008 results reflected lagging sales to corporate customers as a result of slowing economic conditions. In response, the Company concentrated its product sales efforts on its core higher education market and focused its service solutions on addressing corporate markets. The 2009 results reflect increased billings and an increase in higher education as a percentage of total billings from 31% in Q1-2008 to 61% in Q1-2009. Sales consisted of the following:

Product revenue from sale of Mediasite capture units

|  | Q1-2009  | Q1-2008  |
|--|----------|----------|
| Units sold                                     | 183      | 82       |
| Rack to mobile ratio                           | 2.2 to 1 | 1.0 to 1 |
| Average sales price, excluding service (000 s) | \$10.0   | \$10.1   |

Services revenue represents the portion of fees charged for Mediasite 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 \$1.6 million in Q1-2008 to \$2.2 million in Q1-2009 primarily due to an increase in event and content hosing services as well as an increase in support contracts on new Mediasite capture units and renewals of support contracts entered into in prior years. At December 31, 2008 \$4.6 million of unrecognized support and service revenue remained in unearned revenues, of which we expect to realize \$2.0 million in the upcoming quarter.

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

**Gross Margin**

Total gross margin for Q1-2009 were \$3.1 million for a gross margin percentage of 78% compared to Q1-2008 of \$1.9 million or 75%. Gross margin increased primarily due to an increase in the mix of billings from service contracts, which are recognized as revenue over the life of the contract. Our service operations generally result in higher gross margin when they are ultimately recognized. Gross margin was also impacted by unit cost reductions in recorders due to incorporation of a proprietary component. The significant components of cost of revenue include:

Material and freight costs for the Mediasite recorders. Costs for Q1-2009 Mediasite recorder hardware and other costs totaled \$592 thousand, along with \$53 thousand of freight costs, and \$121 thousand of labor and allocated costs compared to Q1-2008 Mediasite recorder costs of \$422 thousand for hardware, \$28 thousand freight and \$59 thousand labor and allocated costs.

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Services costs. Staff wages and other costs allocated to cost of service revenues were \$125 thousand in Q1-2009 and \$113 thousand in Q1-2008, resulting in gross margin on services of 95% in Q1-2009 and 93% in Q1-2008.

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### **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 tradeshows.

#### *Q1-2009 compared to Q1-2008*

Selling and marketing expenses decreased \$883 thousand or 25% from \$3.5 million in Q1-2008 to \$2.7 million in Q1-2009 resulting from:

Q1-2008 salaries and benefits exceeded Q1-2009 by \$421 thousand due to a reduction in our sales staff initiated in January 2008. Our sales staff decreased from 73 at December 31, 2007 to 58 at December 31, 2008. This was partially offset by an increase in incentive compensation of \$200 thousand in Q1-2009 compared to Q1-2008 as a result of higher billings. We expect headcount to remain at or near current levels for the remainder of fiscal 2009.

Q1-2009 travel, and facility expenses decreased \$309 thousand primarily as a result of reduced selling and marketing staff levels.

Q1-2009 professional services, advertising and tradeshows decreased \$264 thousand as a result of certain corporate and other marketing activities that were reduced or eliminated in Q2-2008.

#### **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.

#### *Q1-2009 compared to Q1-2008*

G&A expenses decreased \$195 thousand or 20% over the prior period from \$978 thousand in Q1-2008 to \$783 thousand in Q1-2009. Significant variances between the periods include:

Salaries, incentive compensation and benefits decreased \$113 thousand over the prior year, due primarily to a reduction in headcount.

Professional services decreased by \$133 thousand from prior year primarily due to reduced consulting fees as a result of a cost reduction plan which began in January 2008.

As of December 31, 2008 we had 8 employees in G&A compared to 16 as of December 31, 2007. We anticipate G&A headcount to remain at or near 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.

#### *Q1-2009 compared to Q1-2008*

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R&D expenses decreased \$43 thousand, or 5% from \$946 thousand in Q1-2008 to \$903 thousand in Q1-2009. Some significant differences between the periods include:

Decreased supplies and materials of \$35 thousand.

Decreased share of facilities expenses of \$10 thousand.

As of December 31, 2008 we had 24 employees, excluding interns, in Research and Development compared to 26 at December 31, 2007. We anticipate R&D headcount to remain flat during the remainder of fiscal 2009. We do not anticipate that any fiscal 2009 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.

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### **Other Income**

Other income is primarily interest income from overnight investment vehicles.

### **Liquidity and Capital Resources**

Cash provided by operating activities was \$9 thousand in Q1-2009 compared to cash used in operating activities in Q1-2008 of \$1.7 million. Cash provided in 2009 was impacted by a decrease in the net loss of \$2.3 million from \$3.5 million to \$1.2 million and partially offset by changes in working capital. Working capital changes included the positive effects of reductions in accounts receivable of \$1.3 million and the negative effects of a \$304 thousand decrease in accounts payable and accrued liabilities and a \$55 thousand decrease in unearned revenue. Q2-2008 had more significant changes in working capital components with a \$2.7 million decrease in accounts receivable and an increase of \$460 thousand in inventory and a \$985 thousand decrease in accounts payable and accrued liabilities.

Cash used in investing activities was \$131 thousand in Q1-2009 compared to a use of \$37 thousand in Q1-2008 for the purchase of property and equipment.

Cash used in financing activities was \$82 thousand in Q1-2009 compared to use of \$83 thousand in Q1-2008. These amounts are comprised of cash used for payments on capital leases and note payable and are partially offset by cash received from the exercise of common stock options.

The Company has incurred losses from operations in each of the last three fiscal years. In response to the 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. The Company anticipates operating expenses to remain at or near these reduced levels in fiscal 2009. The Company anticipates growth in billings in fiscal 2009 and believes its cash position is adequate to accomplish its business plan through at least the next twelve months even if billings remain unchanged, and the Company has no plans to seek additional equity financing or to issue additional shares previously registered in its available shelf registration. We may evaluate further operating or capital lease opportunities to finance equipment purchases in the future and may utilize the Company's revolving line of credit or request an increase to the term loan to support working capital needs, if the Company deems it advisable to do so.

On June 16, 2008, the Company entered into an Amended 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. 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 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 \$1.8 million, of which we expect to purchase approximately \$700 thousand over the next fiscal quarter, remain. This commitment is not recorded on the Company's Balance Sheet. The Company had approximately \$459 thousand of purchase commitments as of December 31, 2007.

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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.

The interest rate under our revolving line of credit and term loan is subject to change based on the Silicon Valley Bank's Prime Rate. At December 31, 2008 a balance of \$472 thousand was outstanding on the term loan and there was no outstanding balance on the revolving line of credit.

#### **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, 2008, 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.

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**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, 2008 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

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- 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 Loan and Security Agreement dated May 2, 2007, among Sonic Foundry, Inc., Sonic Foundry Media Systems, Inc. and Silicon Valley Bank filed as Exhibit 10.1 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, Inc. and Silicon Valley Bank filed as Exhibit 10.2 to Form 8-K on May 7, 2007, and hereby incorporated by reference.
- 10.9 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.
- 10.10 Underwriting Agreement dated as of December 20, 2006 between Sonic Foundry, Inc. and Robert W. Baird & Co., filed as Exhibit 10.1 to Form 8-K filed on December 22, 2006, and hereby incorporated by reference.
- 10.11\* 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.

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- 10.12\* Employment Agreement dated October 31, 2007 between Sonic Foundry, Inc. and Darrin T. Coulson, filed as Exhibit 10.2 to Form 8-K filed on November 2, 2007, and hereby incorporated by reference.
- 10.13 First Loan Modification Agreement entered into as of December 19, 2007, among Sonic Foundry, Inc., Sonic Foundry Media Systems, Inc. and Silicon Valley Bank, filed as Exhibit 10.1 to Form 8-K filed on December 21, 2007, and hereby incorporated by reference.
- 10.14 Letter Agreement entered into as of March 25, 2008, among Sonic Foundry, Inc., Sonic Foundry Media Systems, Inc. and Silicon Valley Bank, filed as Exhibit 10.1 to Form 8-K filed on April 2, 2008, and hereby incorporated by reference.
- 10.15 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.
- 10.16 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.
- 31.1 Section 302 Certification of Chief Executive Officer
- 31.2 Section 302 Certification of Chief Financial Officer
- 32 Section 906 Certification of Chief Executive Officer and Chief Financial Officer
- Registrant will furnish upon request to the Securities and Exchange Commission a copy of all exhibits, annexes and schedules attached to each contract referenced in item 10.

\* Compensatory Plan or Arrangement

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***SIGNATURES***

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

Sonic Foundry, Inc.  
(Registrant)

February 6, 2009

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

February 6, 2009

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