SONIC FOUNDRY INC
Form 10-Q
May 02, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly period ended March 31, 2011

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)

MARYLAND	**39-1783372**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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	x

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

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

Class	**Outstanding April 28, 2011**
Common Stock, $0.01 par value	3,777,056

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Item 1

Sonic Foundry, Inc.

Condensed Consolidated Balance Sheets

(in thousands, except for share data)

(Unaudited)

	March 31, 2011	September 30, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 4,208	$ 3,358
Accounts receivable, net of allowance of $90 and $105	3,734	5,038
Inventories	786	541
Prepaid expenses and other current assets	627	433
Total current assets	9,355	9,370
Property and equipment:		
Leasehold improvements	980	980
Computer equipment	2,946	2,597
Furniture and fixtures	461	461
Total property and equipment	4,387	4,038
Less accumulated depreciation	3,132	2,801
Net property and equipment	1,255	1,237
Other assets:		
Goodwill	7,576	7,576
Other intangibles, net of amortization of $96 and $71	59	84
Total assets	$ 18,245	$ 18,267
Liabilities and stockholders equity		
Current liabilities:		
Revolving line of credit	$	$
Accounts payable	684	1,138
Accrued liabilities	607	752
Unearned revenue	4,859	5,486
Current portion of notes payable	777	552
Total current liabilities	6,927	7,928
Long-term portion of unearned revenue	465	587
Long-term portion of notes payable	678	1,040
Other liabilities	42	85
Deferred tax liability	1,610	1,490
Total liabilities	9,722	11,130
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		
Common stock, $.01 par value, authorized 10,000,000 shares; 3,779,074 and 3,650,823 shares issued and 3,766,358 and 3,638,107 shares outstanding	38	37
Additional paid-in capital	187,407	185,973
Accumulated deficit	(178,727)	(178,678)
Receivable for common stock issued	(26)	(26)
Treasury stock, at cost, 12,716 shares	(169)	(169)
Total stockholders equity	8,523	7,137
Total liabilities and stockholders equity	$ 18,245	$ 18,267

See accompanying notes to the condensed consolidated financial statements

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Sonic Foundry, Inc.

Condensed Consolidated Statements of Operations

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

(Unaudited)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010	Six Months Ended March 31, 2011	Six Months Ended March 31, 2010
Revenue:				
Product	$ 2,631	$ 2,509	$ 5,475	$ 4,437
Services	2,839	2,366	5,864	4,914
Other	55	34	116	60
Total revenue	5,525	4,909	11,455	9,411
Cost of revenue:				
Product	1,291	1,114	2,641	1,944
Services	364	119	683	309
Total cost of revenue	1,655	1,233	3,324	2,253
Gross margin	3,870	3,676	8,131	7,158
Operating expenses:				
Selling and marketing	2,443	2,320	4,905	4,538
General and administrative	717	594	1,336	1,397
Product development	862	805	1,696	1,516
Total operating expenses	4,022	3,719	7,937	7,451
Income (loss) from operations	(152)	(43)	194	(293)
Other expense, net	(60)	(28)	(123)	(38)
Loss before income taxes	(212)	(71)	71	(331)
Provision for income taxes	(60)	(60)	(120)	(120)
Net loss	$ (272)	$ (131)	$ (49)	$ (451)
Net loss per common share:				
basic and diluted	$ (0.07)	$ (0.04)	$ (0.01)	$ (0.12)
Weighted average common shares				
basic and diluted	3,732,996	3,614,321	3,693,444	3,610,581

See accompanying notes to the condensed consolidated financial statements

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Sonic Foundry, Inc.

Condensed Consolidated Statements of Cash Flows

(in thousands)

(Unaudited)

	Six months ended March 31, 2011	2010
Operating activities		
Net loss	$ (49)	$ (451)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Amortization of other intangibles	57	18
Depreciation and amortization of property and equipment	331	266
Deferred taxes	120	120
Share-based compensation expense related to stock warrants and options	370	63
Provision for doubtful accounts	(15)	
Changes in operating assets and liabilities:		
Accounts receivable	1,319	(222)
Inventories	(328)	332
Prepaid expenses and other current assets	(194)	33
Accounts payable and accrued liabilities	(599)	(80)
Other long-term liabilities	(43)	(42)
Unearned revenue	(749)	(383)
Net cash provided by (used in) operating activities	220	(346)
Investing activities		
Purchases of property and equipment	(266)	(141)
Net cash used in investing activities	(266)	(141)
Financing activities		
Net payments on line of credit		(300)
Proceeds from notes payable		1,250
Payments on notes payable	(169)	(153)
Payments on debt issuance costs		(66)
Proceeds from exercise of common stock options and warrants	1,033	12
Proceeds from issuance of common stock	32	29
Payments on capital lease obligations		(20)
Net cash provided by financing activities	896	752
Net increase in cash and cash equivalents	850	265
Cash and cash equivalents at beginning of period	3,358	2,598
Cash and cash equivalents at end of period	$ 4,208	$ 2,863

See accompanying notes to the condensed consolidated financial statements

Sonic Foundry, Inc.

Notes to Condensed Consolidated Financial Statements

March 31, 2011

(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 consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) 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 GAAP for complete financial statements. 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 and six month periods ended March 31, 2011 are not necessarily indicative of the results that might be expected for the year ending September 30, 2011.

The condensed consolidated balance sheet at September 30, 2010 has been derived from audited financial statements at that date, but do not include all of the information and disclosures required by GAAP. For a more complete discussion of accounting policies and certain other information, refer to the Company s annual report filed on Form 10-K for the fiscal year ended 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 and 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 when it incurs an obligation for price rebates or other such programs during the period the obligation and sale occurs. 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

The Company sells support and content hosting contracts to their customers, typically one year in length and records the related revenue ratably over the contractual period. 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 the Company contracts with to build the units performs hardware warranty service. The Company also sells 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 when these additional elements are sold with hosting. 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

The Company has historically applied the software revenue recognition rules as prescribed by Accounting Standards Codification (ASC) Subtopic 985-605. In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) Number 2009-14, Certain Revenue Arrangements That Include Software Elements, which amended ASC Subtopic 985-605. This ASU removes tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of the software revenue recognition rules. In the case of the Company s hardware products with embedded software, the Company has determined that the hardware and software components function together to deliver the product s essential functionality, and therefore, the revenue from the sale of these products no longer falls within the scope of the software revenue recognition rules. Revenue from the sale of software-only products remains within the scope of the software revenue recognition rules. Installation, training, and post customer support no longer fall within the scope of the software revenue recognition rules, except when they are sold with and relate to a software-only product. Revenue recognition for products that no longer fall under the scope of the software revenue recognition rules is similar to that for other tangible products. ASU Number 2009-13, Multiple-Deliverable Revenue Arrangements, which amended ASC Topic 605 and was also issued in October 2009, is applicable for multiple-deliverable revenue arrangements. ASU 2009-13 allows companies to allocate revenue in a multiple-deliverable arrangement in a manner that better reflects the transaction s economics. ASU 2009-13 and 2009-14 are effective for revenue arrangements entered into or materially modified in the Company s fiscal year 2011.

Under the software revenue recognition rules, the fee from a multiple-deliverable arrangement is allocated to each of the undelivered elements based upon vendor-specific objective evidence (VSOE), which is limited to the price charged when the same deliverable is sold separately, with the residual value from the arrangement allocated to the delivered element. The portion of the fee that is allocated to each deliverable is then recognized as revenue when the criteria for revenue recognition are met with respect to that deliverable. If VSOE does not exist for all of the undelivered elements, then all revenue from the arrangement is typically deferred until all elements have been delivered to the customer. All revenue arrangements, with the exception of hosting contracts, entered into prior to October 1, 2010 and the sale of all software-only products and associated services have been accounted for under this guidance during the six-month period ended March 31, 2011.

Under the revenue recognition rules for tangible products as amended by ASU 2009-13, the fee from a multiple-deliverable arrangement is allocated to each of the deliverables based upon their relative selling prices as determined by a selling-price hierarchy. A deliverable in an arrangement qualifies as a separate unit of accounting if the delivered item has value to the customer on a stand-alone basis. A delivered item that does not qualify as a separate unit of accounting is combined with the other undelivered items in the arrangement and revenue is recognized for those combined deliverables as a single unit of accounting. The selling price used for each deliverable is based upon VSOE if available, third-party evidence (TPE) if VSOE is not available, and best estimate of selling price (ESP) if neither VSOE nor TPE are available. TPE is the price of the Company s or any competitor s largely interchangeable products or services in stand-alone sales to similarly situated customers. ESP is the price at which the Company would sell the deliverable if it were sold regularly on a stand-alone basis, considering market conditions and entity-specific factors. All revenue arrangements negotiated after September 30, 2010, excluding the sale of all software-only products and associated services, have been accounted for under this guidance during the six-month period ended March 31, 2011.

The selling prices used in the relative selling price allocation method (1) for the Company s products and services are based upon VSOE, (2) for hardware products with embedded software for which VSOE does not exist are based upon ESP. The Company does not believe TPE exists for any of these products and services because they are differentiated from competing products and services in terms of functionality and performance and there are no competing products or services that are largely interchangeable. Management establishes ESP for hardware products with embedded software using a cost plus margin approach with consideration for market conditions, such as the impact of competition and geographic considerations, and entity-specific factors, such as the cost of the product and the Company s profit objectives. Management believes that ESP is reflective of reasonable pricing of that deliverable as if priced on a stand-alone basis.

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While the pricing model, currently in use, captures all critical variables, unforeseen changes due to external market forces may result in a revision of the inputs. These modifications may result in the consideration allocation differing from the one presently in use. Absent a significant change in the pricing inputs or the way in which the industry structures its deals, future changes in the pricing model are not expected to materially affect our allocation of arrangement consideration.

Billings for hosting are spread ratably over the term of the hosting agreement, with the typical hosting agreement having a term of 12 months, with renewal on an annual basis. The Company sells most hosting contracts without the inclusion of products, and occasionally some hosting contracts in conjunction with the sale of product. When the hosting arrangement is sold in conjunction with product, the product revenue is recognized immediately while the remaining hosting revenue is spread ratably over the term of the hosting agreement. The selling price is allocated between these elements using the relative selling price method. The Company uses the estimated selling price method for development of the selling price for hardware products with embedded software.

Reserves

The Company records reserves for stock rotations, price adjustments, rebates, and sales incentives to reduce revenue and accounts receivable for these and other credits granted 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 the Company determines that it can no longer accurately estimate amounts for stock rotations and sales incentives, the Company 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 assess the realization of our receivables by performing ongoing credit evaluations of our customers financial condition. Through these evaluations, we may become aware of a situation where a customer may not be able to meet its financial obligations due to deterioration of its financial viability, credit ratings or bankruptcy. Our reserve requirements are based on the best facts available to us and are reevaluated and adjusted as additional information is received. Our reserves are also based on amounts determined by using percentages applied to certain aged receivable categories. These percentages are determined by a variety of factors including, but not limited to, current economic trends, historical payment and bad debt write-off experience. Allowance for doubtful accounts for accounts receivable was $90,000 as of March 31, 2011 and $105,000 at September 30, 2010.

Cash and Cash Equivalents

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

Inventory Valuation

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

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	March 31, 2011	September 30, 2010
Raw materials and supplies	$ 10	$ 10
Finished goods	776	531
	$ 786	$ 541

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.

Stock Based Compensation

The Company uses a lattice valuation model to account for all employee stock options granted. 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. Forfeitures are based on actual behavior patterns.

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

	Three months ended March 31,	
	2011	2010
Expected life	4.6 years	4.9 years
Risk-free interest rate	1.36%	1.38%
Expected volatility	74.86%	86.90%
Expected forfeiture rate	15.40%	16.27%
Expected dividend yield	0%	0%

A summary of option activity as of March 31, 2011 and changes during the six months then ended is presented below:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Period	Aggregate Intrinsic Value
Outstanding at October 1, 2010	764,718	$ 10.98	5.7	$ 1,412,835
Granted	101,226	14.16	9.8	
Exercised	(72,038)	10.52	1.4	275,016
Forfeited	(10,971)	9.08	8.5	
Outstanding at March 31, 2011	782,935	11.45	6.2	3,697,376
Exercisable at March 31, 2011	559,229	12.16	5.1	2,501,241

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A summary of the status of the Company s non-vested shares and changes during the six month periods ended March 31, 2011 and 2010 are presented below:

	2011		2010	
Non-vested Shares	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Non-vested at October 1,	209,131	$ 4.28	301,015	$ 5.13
Granted	101,226	8.24	40,950	3.50
Vested	(77,063)	6.10	(72,689)	7.06
Forfeited	(9,588)	4.12	(12,894)	5.20
Non-vested at March 31,	223,706	$ 4.89	256,382	$ 4.33

The weighted average grant date fair value of options granted during the six months ended March 31, 2011 was $8.24. As of March 31, 2011, there was $774 thousand of total unrecognized compensation cost related to non-vested share-based compensation, including $624 thousand of estimated forfeitures. The cost is expected to be recognized over a weighted-average remaining life of 2.08 years.

Stock-based compensation recorded in the three month period ended March 31, 2011 of $192 thousand was allocated $131 thousand to selling and marketing expenses, $13 thousand to general and administrative expenses, and $48 thousand to product development expenses. Stock-based compensation recorded in the six month period ended March 31, 2011 of $370 thousand was allocated $254 thousand to selling and marketing expenses, $24 thousand to general and administrative expenses, and $92 thousand to product development expenses. Cash received from option and warrant exercises under all stock option plans for the three and six month periods ended March 31, 2011 was $659 thousand and $1.03 million, respectively. Cash received from option and warrant exercises under all stock option plans for the three and six month periods ended March 31, 2010 was $13 thousand. There were no tax benefits realized for tax deductions from option exercises in either of the six month periods ended March 31, 2011 or 2010. The Company currently expects to satisfy share-based awards with registered shares available to be issued.

The Company also has an Employee Stock Purchase Plan (Purchase Plan) under which an aggregate of 100,000 common shares may be issued. The Shareholders approved an amendment to increase the number of shares of common stock subject to the plan from 50,000 to 100,000 at the Company s annual meeting in March 2011. 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 5,405 shares purchased by employees for the six month offering ended December 31, 2010 which were issued in January 2011. A total of 50,418 shares are available to be issued under the plan. Due to the timing of the increase of shares pursuant to the plan, the Company did not offer any shares for purchase during the six month period ending June 30, 2011.

Per share computation

Basic and diluted net income (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

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dilutive effects of options and warrants. In periods where the Company reports net income, diluted net income per share is 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:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2011	**2010**	**2011**	**2010**
Denominator				
Denominator for basic earnings per share weighted average common shares	3,732,996	3,614,321	3,693,444	3,610,581
Effect of dilutive options and warrants (treasury method)				
Denominator for diluted earnings per share adjusted weighted average common shares	3,732,996	3,614,321	3,693,444	3,610,581
Options and warrants outstanding during each period, but not included in the computation of diluted earnings per share because they are antidilutive	793,485	865,485	793,485	865,485

New Accounting Pronouncements

The Company adopted in October 2010, the 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. Entities must adopt the amendments resulting from both of these ASUs in the same period using the same transition method, where applicable. The adoption of these ASUs did not have a material impact on the Company s consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (ASU 2010-20). The standard amends ASC Topic 310, *Receivables* to enhance disclosures about the credit quality of financing receivables and the allowance for credit losses by requiring an entity to provide a greater level of disaggregated information and to disclose credit quality indicators, past due information, and modifications of its financing receivables. ASU 2010-20 is effective for interim or annual fiscal years beginning after December 15, 2010. The Company s adoption of ASU 2010-20 did not have a material impact on its consolidated financial statements.

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In December 2010 the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-28, Intangibles Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts . ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts by requiring an entity to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. This update will be effective for fiscal years beginning after December 15, 2010. The adoption of this guidance is not expected to have an impact on the Company s consolidated financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the Company s financial statements upon adoption.

2. Related Party Transactions

During the three and six month periods ended March 31, 2011, the Company incurred fees of $69 thousand and $117 thousand, respectively, to a law firm, a partner of which is a director and stockholder of the Company. The Company incurred similar fees of $65 thousand and $130 thousand, respectively, during the three and six month periods ended March 31, 2010. The Company had accrued liabilities for unbilled services of $38 thousand at March 31, 2011 and $54 thousand at September 30, 2010, respectively, to the same law firm.

During the three and six month periods ended March 31, 2011, the Company recorded Mediasite product and customer support billings of $222 thousand and $432 thousand, respectively, to Mediasite KK, a Japanese reseller in which the Company has an equity interest. The Company recorded billings of $237 thousand and $373 thousand, respectively, in the three and six month periods ended March 31, 2010. Mediasite KK owed the Company $223 thousand at March 31, 2010 and $63 thousand at September 30, 2010. The Company accounts for its investment in Mediasite KK under the equity method. The recorded value of this investment as of March 31, 2011 and September 30, 2010 is zero.

As of March 31, 2011 and September 30, 2010, the Company had a loan outstanding to an executive totaling $26 thousand. This loan is secured by Company stock.

3. Purchase Commitments

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. As of March 31, 2011, the Company had outstanding commitments to purchase $2.33 million of Mediasite product, which is not recorded on the Company s Condensed Consolidated Balance Sheet.

4. Borrowing Arrangements

Silicon Valley Bank

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 as defined below, was to be repaid in full on May 1, 2010.

On April 14, 2009, the Company executed the First Amendment to the Amended Loan Agreement with Silicon Valley Bank (the First Amendment). The First Amendment, among other things, a) refinanced 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) continued to require a reserve under the Revolving Line for the balance of the term loan 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) modified the minimum requirements under the EBITDA covenant, which currently requires a positive EBITDA, but maintained a provision to override such covenant if the Company maintains a minimum Adjusted Quick Ratio of 1.75 to 1.00; and d) extended the maturity date of the Revolving Line to October 1, 2011 and the Term Loan 2 to April 1, 2012. The First Amendment also requires the Company to continue to maintain certain of their depository, operating and securities accounts with Silicon Valley Bank, and to continue to comply with 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 March 31, 2011, a balance of $391 thousand was outstanding on the term loan and no balance was outstanding on the revolving line of credit. At March 31, 2011, there was $1.8 million available under this credit facility for advances. The Company believes it can renew the Revolving Line under similar terms and conditions. At March 31, 2011 the Company was in compliance with all covenants in the Amended Loan Agreement, as amended by the First Amendment.

The Amended Loan Agreement, as amended by the First Amendment, 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, as amended by the First Amendment.

Pursuant to the Amended Loan Agreement, as amended by the First Amendment, 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.

Partners for Growth

On March 5, 2010, Sonic Foundry, Inc., and its wholly-owned subsidiary, Sonic Foundry Media Systems, Inc. (SFMS) executed the $1,250,000 Loan and Security Agreement (the Term Loan) and the $750,000 Revolving Loan and Security Agreement (the Revolving Loan) with Partners for Growth II, L.P. (PFG), (collectively the Agreements).

The Term Loan bears interest at 11.75% per annum with principal due in 36 equal monthly payments of $34,722 beginning April 1, 2011 and continuing through March 1, 2014. At March 31, 2011, a balance of $1,250,000 was outstanding on the Term Loan.

The Term Loan is collateralized by substantially all the Company s assets, including intellectual property, subject to a first lien held by Silicon Valley Bank, requires compliance with an adjusted quick ratio covenant of 1.75:1.00. As of March 31, 2011, the Company was in compliance with this covenant.

Coincident with execution of the Agreements, the Company entered into a Warrant Purchase Agreement (Purchase Agreement) and a Warrant Agreement (Warrant) with PFG. Pursuant to the terms of the Purchase Agreement, PFG purchased a warrant to purchase up to 76,923 shares of common stock of the Company at an exercise price of $6.25 per share, subject to certain adjustments, for a purchase price of $3,333. A warrant to purchase 48,077 shares of common stock was immediately exercisable. PFG exercised 24,039 shares in November 2010 and the remaining 24,038 shares in January 2011. Both such warrant exercise transactions were completed on a cashless basis resulting in 14,595 and 13,712 shares issued, respectively. The remaining warrant to purchase 28,846 shares of common stock has terminated.

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The Company valued the warrants issued pursuant to the Purchase Agreement using the Black-Scholes method assuming a 1) life of seven years; 2) volatility factor of 86.9%; 3) risk free interest rate of 1.38%. The resulting value of the warrants, less $3,333 proceeds received from PFG, is treated as a debt discount and netted against the carrying value of the Term Loan on the consolidated balance sheet. The discount is amortized at a constant rate applied to the outstanding balance of the Term Loan with a corresponding increase to non-cash interest expense. At March 31, 2011 the remaining balance of the discount was $186 thousand.

5. 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.

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.

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 March 31, 2011 was $1.61 million and at September 30, 2010 was $1.49 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 Condensed Consolidated Balance Sheets at September 30, 2010 or March 31, 2011, and has not recognized any interest or penalties in the Condensed Consolidated Statements of Operations for either the three or six month periods ended March 31, 2011 or 2010.

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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, 2010. 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 in order to purchase products and services such as the Company provides. 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.

In response to global economic conditions, many manufacturers and distributors have reduced the level of inventory they maintain as well as their staff levels. As a result, many components, including some of which the Company requires to build its products, are in short supply and have lengthening lead times for delivery. While we believe there are multiple sources of supply for our products and the component parts required to build them, even a short term disruption of supply of component parts or completed products near the end of a quarter would have a negative impact on our revenues. As a result of the foregoing, we may not be able to meet demand for our products, which could negatively affect revenues in the quarter of the disruption or longer depending upon the magnitude of the event, and could harm our reputation.

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.

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New Accounting Pronouncements

The Company adopted in October 2010, the 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. Entities must adopt the amendments resulting from both of these ASUs in the same period using the same transition method, where applicable. The adoption of these ASUs did not have a material impact on the Company s consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (ASU 2010-20). The standard amends ASC Topic 310, *Receivables* to enhance disclosures about the credit quality of financing receivables and the allowance for credit losses by requiring an entity to provide a greater level of disaggregated information and to disclose credit quality indicators, past due information, and modifications of its financing receivables. ASU 2010-20 is effective for interim or annual fiscal years beginning after December 15, 2010. The Company s adoption of ASU 2010-20 did not have a material impact on its consolidated financial statements.

In December 2010 the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-28, Intangibles Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts . ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts by requiring an entity to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. This update will be effective for fiscal years beginning after December 15, 2010. The adoption of this guidance is not expected to have an impact on the Company s 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 when it incurs an obligation for price rebates or other such programs during the period the obligation and sale occurs. 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 our server software.

Services

We sell support and content hosting contracts to our customers, typically one year in length, and records 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 when these additional elements are sold with hosting. 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

The Company has historically applied the software revenue recognition rules as prescribed by Accounting Standards Codification (ASC) Subtopic 985-605. In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) Number 2009-14, Certain Revenue Arrangements That Include Software Elements, which amended ASC Subtopic 985-605. This ASU removes tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of the software revenue recognition rules. In the case of the Company s hardware products with embedded software, the Company has determined that the hardware and software components function together to deliver the product s essential functionality, and therefore, the revenue from the sale of these products no longer falls within the scope of the software revenue recognition rules. Revenue from the sale of software-only products remains within the scope of the software revenue recognition rules. Installation, training, and post customer support no longer fall within the scope of the software revenue recognition rules, except when they are sold with and relate to a software-only product. Revenue recognition for products that no longer fall under the scope of the software revenue recognition rules is similar to that for other tangible products. ASU Number 2009-13, Multiple-Deliverable Revenue Arrangements, which amended ASC Topic 605 and was also issued in October 2009, is applicable for multiple-deliverable revenue arrangements. ASU 2009-13 allows companies to allocate revenue in a multiple-deliverable arrangement in a manner that better reflects the transaction s economics. ASU 2009-13 and 2009-14 were adopted and are effective for revenue arrangements entered into or materially modified in the Company s fiscal year 2011.

Under the software revenue recognition rules, the fee from a multiple-deliverable arrangement is allocated to each of the undelivered elements based upon vendor-specific objective evidence (VSOE), which is limited to the price charged when the same deliverable is sold separately, with the residual value from the arrangement allocated to the delivered element. The portion of the fee that is allocated to each deliverable is then recognized as revenue when the criteria for revenue recognition are met with respect to that deliverable. If VSOE does not exist for all of the undelivered elements, then all revenue from the arrangement is typically deferred until all elements have been delivered to the customer. All revenue arrangements, with the exception of hosting contracts, entered into prior to October 1, 2010 and the sale of all software-only products and associated services have been accounted for under this guidance during the six-month period ended March 31, 2011.

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Under the revenue recognition rules for tangible products as amended by ASU 2009-13, the fee from a multiple-deliverable arrangement is allocated to each of the deliverables based upon their relative selling prices as determined by a selling-price hierarchy. A deliverable in an arrangement qualifies as a separate unit of accounting if the delivered item has value to the customer on a stand-alone basis. A delivered item that does not qualify as a separate unit of accounting is combined with the other undelivered items in the arrangement and revenue is recognized for those combined deliverables as a single unit of accounting. The selling price used for each deliverable is based upon VSOE if available, third-party evidence (TPE) if VSOE is not available, and best estimate of selling price (ESP) if neither VSOE nor TPE are available. TPE is the price of the Company s or any competitor s largely interchangeable products or services in stand-alone sales to similarly situated customers. ESP is the price at which the Company would sell the deliverable if it were sold regularly on a stand-alone basis, considering market conditions and entity-specific factors. All revenue arrangements negotiated after September 30, 2010, excluding the sale of all software-only products and associated services, have been accounted for under this guidance during the six-month period ended March 31, 2011.

The selling prices used in the relative selling price allocation method (1) for the Company s products and services are based upon VSOE, (2) for hardware products with embedded software for which VSOE does not exist are based upon ESP. The Company does not believe TPE exists for any of these products and services because they are differentiated from competing products and services in terms of functionality and performance and there are no competing products or services that are largely interchangeable. Management establishes ESP for hardware products with embedded software using a cost plus margin approach with consideration for market conditions, such as the impact of competition and geographic considerations, and entity-specific factors, such as the cost of the product and the Company s profit objectives. Management believes that ESP is reflective of reasonable pricing of that deliverable as if priced on a stand-alone basis.

While the pricing model, currently in use, captures all critical variables, unforeseen changes due to external market forces may result in a revision of the inputs. These modifications may result in the consideration allocation differing from the one presently in use. Absent a significant change in the pricing inputs or the way in which the industry structures its deals, future changes in the pricing model are not expected to materially affect our allocation of arrangement consideration.

Billings for hosting are spread ratably over the term of the hosting agreement, with the typical hosting agreement having a term of 12 months, with renewal on an annual basis. The Company sells most hosting contracts without the inclusion of products, and occasionally some hosting contracts in conjunction with the sale of product. When the hosting arrangement is sold in conjunction with product, the product revenue is recognized immediately while the remaining hosting revenue is spread ratably over the term of the hosting agreement. The selling price is allocated between these elements using the relative selling price method. The Company uses the estimated selling price method for development of the selling price for hardware products with embedded software.

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 assess the realization of our receivables by performing ongoing credit evaluations of our customers financial condition. Through these evaluations, we may become aware of a situation where a customer may not be able to meet its financial obligations due to deterioration of its financial viability, credit ratings or bankruptcy. Our reserve requirements are based on the best facts available to us and are reevaluated and adjusted as additional information is received. Our reserves are also based on amounts determined by using percentages applied to certain aged receivable categories. These percentages are determined by a variety of factors including, but not limited to, current economic trends, historical payment and bad debt write-off experience. Allowance for doubtful accounts for accounts receivable was $90,000 as of March 31, 2011 and $105,000 at September 30, 2010.

Impairment of long-lived assets

We assess the impairment of goodwill 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 FASB ASC-360-10. 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.