

SONIC FOUNDRY INC  
Form 10-Q  
August 08, 2008  
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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 June 30, 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	August 6, 2008 35,601,670

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**Table of Contents****PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements****Sonic Foundry, Inc.****Consolidated Balance Sheets****(in thousands, except for share data)****(Unaudited)**

	<b>June 30, 2008</b>	<b>September 30, 2007</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 3,343	\$ 8,008
Accounts receivable, net of allowances of \$140 and \$270	4,183	5,001
Inventories	319	204
Prepaid expenses and other current assets	463	975
<b>Total current assets</b>	<b>8,308</b>	<b>14,188</b>
Property and equipment:		
Leasehold improvements	980	975
Computer equipment	2,460	2,267
Furniture and fixtures	461	461
<b>Total property and equipment</b>	<b>3,901</b>	<b>3,703</b>
Less accumulated depreciation	2,031	1,520
<b>Net property and equipment</b>	<b>1,870</b>	<b>2,183</b>
Other assets:		
Goodwill and other intangibles, net of amortization of \$1,666 and \$1,656	7,600	7,610
<b>Total assets</b>	<b>\$ 17,778</b>	<b>\$ 23,981</b>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 1,406	\$ 1,512
Accrued liabilities	1,056	1,023
Unearned revenue	3,641	3,314
Current portion of notes payable	333	333
Current portion of capital lease obligations	52	66
<b>Total current liabilities</b>	<b>6,488</b>	<b>6,248</b>
Long-term portion of notes payable	305	556
Long-term portion of capital lease obligations	36	69
Other liabilities	279	348
<b>Total liabilities</b>	<b>7,108</b>	<b>7,221</b>
Stockholders' equity:		

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Preferred stock, \$.01 par value, authorized 5,000,000 shares; none issued and outstanding		
5% preferred stock, Series B, voting, cumulative, convertible, \$.01 par value (liquidation preference at par), authorized 10,000,000 shares, none issued and outstanding		
Common stock, \$.01 par value, authorized 100,000,000 shares; 35,728,837 and 35,684,503 shares issued and 35,601,670 and 35,557,336 shares outstanding	357	357
Additional paid-in capital	184,095	183,528
Accumulated deficit	(173,577)	(166,930)
Receivable for common stock issued	(36)	(26)
Treasury stock, at cost, 127,167 shares	(169)	(169)
Total stockholders' equity	10,670	16,760
<b>Total liabilities and stockholders' equity</b>	<b>\$ 17,778</b>	<b>\$ 23,981</b>

See accompanying notes

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

(in thousands, except for share data)

(Unaudited)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2008	2007	2008	2007
<b>Revenue:</b>				
Product	\$ 3,022	\$ 3,544	\$ 6,146	\$ 9,028
Services	2,028	1,148	5,305	2,939
Other	37	10	85	29
<b>Total revenue</b>	<b>5,087</b>	<b>4,702</b>	<b>11,536</b>	<b>11,996</b>
<b>Cost of revenue:</b>				
Product	1,133	1,095	2,613	2,628
Services	171	131	467	262
<b>Total cost of revenue</b>	<b>1,304</b>	<b>1,226</b>	<b>3,080</b>	<b>2,890</b>
<b>Gross margin</b>	<b>3,783</b>	<b>3,476</b>	<b>8,456</b>	<b>9,106</b>
<b>Operating expenses:</b>				
Selling and marketing	3,295	3,354	10,171	8,900
General and administrative	530	952	2,244	3,027
Product development	778	837	2,706	2,318
<b>Total operating expenses</b>	<b>4,603</b>	<b>5,143</b>	<b>15,121</b>	<b>14,245</b>
<b>Loss from operations</b>	<b>(820)</b>	<b>(1,667)</b>	<b>(6,665)</b>	<b>(5,139)</b>
Other income (expense), net	(9)	77	18	208
<b>Net loss</b>	<b>\$ (829)</b>	<b>\$ (1,590)</b>	<b>\$ (6,647)</b>	<b>\$ (4,931)</b>
<b>Net loss per common share:</b>				
basic and diluted	\$ (0.02)	\$ (0.04)	\$ (0.19)	\$ (0.14)
<b>Weighted average common shares</b>				
basic and diluted	35,582,989	35,504,939	35,572,276	34,400,290

See accompanying notes

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

	<b>Nine months ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating activities</b>		
Net loss	\$ (6,647)	\$ (4,931)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of other intangibles	10	53
Depreciation and amortization of property and equipment	511	472
Loss on sale of fixed assets	5	1
Other non-cash items	106	(59)
Share-based compensation expense related to stock warrants and options	528	590
Provision for doubtful accounts	(130)	100
Changes in operating assets and liabilities:		
Accounts receivable	948	(2,337)
Inventories	(115)	295
Prepaid expenses and other current assets	272	(432)
Accounts payable and accrued liabilities	(73)	(220)
Other long-term liabilities	(69)	(70)
Unearned revenue	461	922
<b>Net cash used in operating activities</b>	<b>(4,193)</b>	<b>(5,616)</b>
<b>Investing activities</b>		
Purchases of property and equipment	(203)	(397)
<b>Net cash used in investing activities</b>	<b>(203)</b>	<b>(397)</b>
<b>Financing activities</b>		
Proceeds from notes payable, net of capitalized loan fees		976
Payments on notes payable	(251)	(28)
Proceeds from issuance of common stock, net of issuance costs		10,392
Proceeds from exercise of common stock options	29	311
Payments on capital leases	(47)	(35)
<b>Net cash provided by (used in) financing activities</b>	<b>(269)</b>	<b>11,616</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(4,665)</b>	<b>5,603</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>8,008</b>	<b>2,751</b>
<b>Cash and cash equivalents at end of period</b>	<b>\$ 3,343</b>	<b>\$ 8,354</b>

See accompanying notes

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**Sonic Foundry, Inc.**

**Notes to Consolidated Financial Statements**

**June 30, 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, 2007. In the opinion of management, all adjustments (consisting only of adjustments of a normal and recurring nature) considered necessary for a fair presentation of the results of operations have been included. Operating results for the three and nine month periods ended June 30, 2008 are not necessarily indicative of the results that might be expected for the year ending September 30, 2008.

***Revenue Recognition***

**General**

Revenue is recognized when persuasive evidence of an arrangement exists, delivery occurs or services are rendered, the sales price is fixed or determinable and collectibility is reasonably assured. Revenue is deferred when undelivered products or services are essential to the functionality of delivered products, customer acceptance is uncertain, significant obligations remain, or the fair value of undelivered elements is unknown. The Company does not offer customers the right to return product, other than for warranty repairs. The Company's policy is to reduce revenue if it incurs an obligation for price rebates or other such programs during the period the obligation is reasonably estimated to occur. The following policies apply to the Company's major categories of revenue transactions.

**Products**

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

**Services**

We sell support contracts to our Mediasite customers, typically one year in length and record the related revenue ratably over the contractual period. Our support contracts cover phone and electronic technical support availability over and above the level provided by our distributors, software upgrades, advance replacement and an extension of the standard hardware warranty from 90 days to one year. The manufacturer we contract with to build the units performs hardware warranty service. We also provide installation, training and event services as well as services to host customer Mediasite content. Revenue for those services is recognized when performed in the case of installation, training and event services and is recognized ratably over the contract period for hosting services. Service amounts invoiced to customers in excess of revenue recognized are recorded as unearned revenue until the revenue recognition criteria are met.



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### Other

Other revenue consists of shipping and handling. Shipping and handling is recorded at the time of shipment to the customer.

### Revenue Arrangements that Include Multiple Elements

Revenue for transactions that include multiple elements such as hardware, software, training, support or content hosting agreements is allocated to each element based on vendor-specific objective evidence of the fair value *VSOE* and recognized for each element when the revenue recognition criteria have been met for that element. *VSOE* is based on the price charged when the element is sold separately. If *VSOE* of fair value does not exist for all elements in a multiple element arrangement, revenue is allocated first to the fair value of the undelivered elements and the residual revenue to the delivered elements. The Company recognizes revenue for delivered elements only when all of the following criteria are satisfied: undelivered elements are not essential to the functionality of delivered elements, uncertainties regarding customer acceptance are resolved, and the fair value for all undelivered elements is known.

### Reserves

We record reserves for stock rotations, rebates, and sales incentives to reduce revenue and accounts receivable for these and other credits we may grant to resellers. 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 reseller behavior. If actual reseller 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 defer recognition of 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 recorders and finished Mediasite recorders. Inventory of completed Mediasite recorders and spare parts are carried at the lower of cost or market, with cost determined on a first-in, first-out basis. Inventory consists of the following (in thousands):

	6/30/08	9/30/07
Raw materials and supplies	\$ 10	\$ 10
Finished goods	309	194
	\$ 319	\$ 204

***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.

Effective October 1, 2005, the Company adopted the provisions of Statement of Financial Accounting Standard No. 123R, Share-Based Payment an Amendment of FASB Statement Nos. 123 and 95, (SFAS 123R) for its stock option plans. The Company previously accounted for these plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and related interpretations and disclosure requirements established by Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation, (SFAS 123), as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure.

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized for the three month periods ended June 30, 2008, and 2007 includes the cost associated with stock options vesting during the period which were granted prior to, but not yet vested as of October 1, 2005. This cost was based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. The cost for all share-based awards granted subsequent to September 30, 2005, represents the grant-date fair value that was estimated in accordance with the provisions of SFAS 123R. Results for prior periods have not been restated. Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period. There were no capitalized stock-based compensation costs at June 30, 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 employee 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

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expected term of options granted is derived from the output of the option pricing model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual term of the options is based on the U.S. Treasury yields in effect at the time of grant.

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

Method	Three months ended June 30,	
	2008	2007
Expected life (years)	Lattice	Lattice
Risk-free interest rate	5.9 years	5.7 years
Expected volatility	2.55%	4.60%
Expected dividend yield	73.25%	65.41%
	0%	0%

A summary of option activity as of June 30, 2008 and changes during the nine months then ended is presented below:

Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Period	Aggregate Intrinsic Value
Outstanding at October 1, 2007	4,712,322	\$ 2.41	5.8	\$ 3,517,856
Granted	2,637,750	1.16	9.6	
Exercised	(44,334)	0.69	3.3	5,550
Forfeited	(950,927)	1.96	7.0	
Outstanding at June 30, 2008	6,354,811	2.04	6.0	45,750
Exercisable at June 30, 2008	4,230,860	\$ 2.37	4.3	\$ 45,750

A summary of the status of the Company's non-vested shares and changes during the nine month periods ended June 30, 2008 and 2007 are presented below:

Non-vested Shares	2008		2007	
	Shares	Weighted-Average Grant Date Fair Value	Shares	Weighted-Average Grant Date Fair Value
Non-vested at October 1,	1,073,194	\$ 1.41	1,124,514	\$ 1.06
Granted	2,625,250	0.56	563,085	1.95
Vested	(1,052,151)	0.68	(424,915)	1.01
Forfeited	(522,342)	1.13	(74,495)	1.33
Non-vested at June 30,	2,123,951	\$ 0.79	1,188,189	\$ 1.38

The weighted average grant date fair value of options granted during the nine months ended June 30, 2008 was \$0.56. As of June 30, 2008, there was \$933 thousand of total unrecognized compensation cost related to non-vested share-based compensation, net of \$333 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 June 30, 2008 of \$37 thousand was allocated \$(30) thousand to selling and marketing expenses, \$18 thousand to general and administrative expenses and \$49 thousand to product development expenses. The selling and

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marketing stock compensation expense includes a credit of \$151 thousand resulting from employment separation of the Company's former Chief Operating

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Officer. Stock-based compensation recorded in the nine month period ended June 30, 2008 of \$528 thousand was allocated \$281 thousand to selling and marketing expenses, \$80 thousand to general and administrative expenses and \$167 thousand to product development expenses. Cash received from option exercises under all stock option plans for the three month period ended June 30, 2007 was \$69 thousand. There was no such cash received during the three month period ended June 30, 2008. There were no tax benefits realized for tax deductions from option exercises in either of the three month periods ended June 30, 2008 and 2007. The Company currently expects to satisfy share-based awards with registered shares available to be issued.

**Per share computation**

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

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2008	2007	2008	2007
<b>Denominator</b>				
Denominator for basic and diluted loss per share weighted average common shares	35,582,989	35,504,939	35,572,276	34,400,290
Securities outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive:				
Options and warrants	6,921,219	5,284,896	6,921,219	5,284,896

**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 ( FAS 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.

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

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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 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 financial statements.

**2. Related Party Transactions**

During the three and nine month periods ended June 30, 2008, the Company incurred fees of \$67 thousand and \$191 thousand, respectively, to a law firm, a partner of which is a director and stockholder of the Company. The Company incurred similar fees of \$63 and \$115 thousand, respectively, during the three and nine month periods ended June 30, 2007. The Company had accrued liabilities for unbilled services of \$22 and \$92 thousand for the periods ended June 30, 2008 and 2007 respectively, to the same law firm.

During the three and nine month periods ended June 30, 2008, the Company billed MSKK, a Japanese reseller in which the Company has an equity interest, \$90 and \$472 thousand, respectively for Mediasite products and customer support services. The Company recorded billings of \$127 and \$452 thousand in the three and nine month periods ended June 30, 2007.

During the nine month period ended June 30, 2007, the Company entered into a transaction with an entity in which a member of the Company's Board of Directors is a significant shareholder. The transaction included a \$57 thousand sale of the Company's product in exchange for advertising services. No sales to the entity were recorded during the nine months ended June 30, 2008.

As of June 30, 2008 and 2007, 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. Obligations of approximately \$598 thousand, all of which we expect to purchase over the next fiscal quarter, remain. This commitment is not recorded on the Company's Balance Sheet. The Company had \$815 thousand of purchase commitments as of June 30, 2007.

**4. Borrowing Arrangements**

On May 2, 2007, the Company and its wholly-owned subsidiary, Sonic Foundry Media Systems, Inc. (collectively, the Companies ) entered into a Loan and Security Agreement (the 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 revolving line of credit will accrue interest at a per annum rate equal to the greater of (i) one-quarter of one percentage point (0.25%) above Silicon Valley Bank's Prime Rate, or (ii) eight percent (8%). The term loan accrues interest at a per annum rate equal to the greater of (i) one percent (1%) above Silicon Valley Bank's Prime Rate, or (ii) eight and three quarters percent (8.75%). Interest on the revolving line of credit and interest on the term loan is payable monthly. The revolving line of credit matures on April 30, 2009, 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 will be repaid in thirty-six (36) equal monthly installments, and

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will be repaid in full on May 1, 2010. The term loan provides funds for the Company's recently completed facility expansion while the revolving line of credit provides flexibility in financing growth in the future, if and when the Company determines it is advisable to do so. At June 30, 2008 a balance of \$638 thousand was remaining on the term loan with no outstanding balance on the revolving line of credit.

The 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, maintain a tangible net worth covenant, and maintain certain ratios of quick assets to current liabilities minus deferred revenue. The 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 Companies were in compliance with all covenants at June 30, 2008.

The 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 Loan Agreement.

Pursuant to the Loan Agreement, the Companies pledged as collateral to the Bank substantially all of their non-intellectual property business assets, and each of the Companies entered into an Intellectual Property Security Agreement with respect to their intellectual property assets.

On December 17, 2007, the Companies executed the First Loan Modification Agreement (the December 2007 Agreement) with Silicon Valley Bank.

The December 2007 Agreement, among other things, a) removed a sub-limit of maximum indebtedness under the revolving line of credit of \$1,000,000 prior to completion of a collateral audit; b) modified certain covenants including a reduction of the tangible net worth covenant as of September 30, 2007 from \$8,000,000 to \$5,500,000; and c) adjusted the definition of Eligible Accounts to, among other things, (i) include certain international accounts up to a maximum of \$750,000, (ii) adjust the concentration limit with respect to a certain Account Debtor and (iii) remove the ineligibility of accounts reflected in deferred revenue.

On March 31, 2008, the Companies entered into a letter agreement dated March 25, 2008 (the March 2008 Agreement) with Silicon Valley Bank. The March 2008 Agreement reduced the tangible net worth covenant as of March 31, 2008 from \$5,500,000 to \$2,800,000, plus, in each case, fifty percent (50%) of the Company's net income and new equity or subordinated debt (as defined).

On June 16, 2008, the Companies entered into an amended and restated loan and security agreement dated June 16, 2008 (the Amended Agreement) with Silicon Valley Bank. Under the Amended Agreement, 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 1/2%) above Silicon Valley's prime rate, or seven and one-half percent (7 1/2%). 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%). Further, under the Amended Agreement, (i) the tangible net worth covenant has been removed, and (ii) a covenant relating to EBITDA (EBITDA Covenant) has been added; 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.

**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

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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.

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, 2007 and at June 30, 2008, and has not recognized any interest or penalties in the Statement of Operations for the nine month period ended June 30, 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. 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, indicates that in accordance with Marketplace Rule 4450(e)(2), the Company will be provided 180 calendar days, or until September 8, 2008, to regain compliance with the Rule. The letter further indicates that the Company may regain compliance if at any time before September 8, 2008, the bid price of the Company's common stock closes at \$1.00 per share or above for a minimum of 10 consecutive trading days. If the Company is successful in meeting this requirement, the Staff will provide written notification that it has achieved compliance with the Rule.

If compliance with the Rule cannot be demonstrated by September 8, 2008, the Company may consider applying to transfer its securities to The Nasdaq Capital Market provided that the Company meets The Nasdaq Capital Market initial listing criteria as set forth in Marketplace Rule 4310(c), except for the bid price requirement. If it elects to transfer its securities and meets the initial listing criteria, the Staff will notify the Company that it has been granted an additional 180 calendar day compliance period. If the Company is not eligible for an additional compliance period or if the Company elects not to transfer its securities to The Nasdaq Capital Market, the Staff will provide written notification that the Company's securities will be delisted. At that time, the Company may appeal the Staff's determination to delist its common stock.

The Company intends to actively monitor the bid price for its common stock between now and September 8, 2008, 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, 2007. In addition to historical information, this discussion contains forward-looking statements such as statements of the Company's expectations, plans, objectives and beliefs. These statements use such words as may, will, expect, anticipate, believe, plan, and other similar terminology.

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

Other factors that may impact actual results include: the length of time necessary to close on sales leads to multi-unit purchasers, the mix of product and service orders, channel inventory levels, 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. (Sonic Foundry) is a technology leader in the emerging web communications marketplace, providing enterprise solutions and services that link an information-driven world. Our core solution, Mediasite<sup>®</sup>, is a web communication and content management system that automatically and cost-effectively lets organizations create affordable multimedia webcasts and gives them the tools to manage, monitor and secure their presentations. In the short time since we first introduced Mediasite, the system has set the standard as a transformational communications medium, changing the way organizations communicate via the web and how people around the globe receive vital information needed for work, professional advancement, safety and education. Trusted by Fortune 500 companies, top education institutions and Federal, state and local government agencies for a variety of critical communication needs, we believe 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 ( FAS 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.

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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 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 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 and allowance for doubtful accounts;

Impairment of long-lived assets;

Valuation allowance for net deferred tax assets; and

Accounting for stock-based compensation.

*Revenue Recognition and Allowance for Doubtful Accounts*

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

We record reserves for stock rotations, rebates, and sales incentives to reduce revenue and accounts receivable for these and other credits we may grant to resellers. 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 reseller behavior. If actual reseller 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 defer recognition of revenue until resellers sell the inventory to the final end user.



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

### *Impairment of long-lived assets*

We assess the impairment of goodwill, other intangibles and capitalized software development costs on an annual basis or whenever events or changes in circumstances indicate that the fair value of these assets is less than the carrying value. Factors we consider important which could trigger an impairment review include the following:

poor economic performance relative to historical or projected future operating results;

significant negative industry, economic or company specific trends;

changes in the manner of our use of the assets or the plans for our business; and

loss of key personnel

If we determine that the fair value of goodwill is less than its carrying value, based upon the annual test or the existence of one or more of the above indicators of impairment, we would then measure impairment based on a comparison of the implied fair value of goodwill with the carrying amount of goodwill. To the extent the carrying amount of goodwill is greater than the implied fair value of goodwill, we would record an impairment charge for the difference.

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

### *Accounting for Income Taxes*

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, 2007 and at June 30, 2008, and has not recognized any interest or penalties in the Statement of Operations for the nine month period ended June 30, 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.



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

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized in the three and nine month periods ended June 30, 2008 includes the cost for all stock options granted prior to, but not yet vested as of October 1, 2005. This cost was based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. The cost for all share-based awards granted subsequent to September 30, 2005, represents the grant-date fair value that was estimated in accordance with the provisions of SFAS 123R. Results for prior periods have not been restated. Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period.

Upon the adoption of SFAS 123R, the Company changed its option valuation model from the Black-Scholes model to a lattice valuation model for all employee stock options granted subsequent to September 30, 2005. The lattice valuation model is a more flexible analysis to value employee options because of its ability to incorporate inputs that change over time, such as actual exercise behavior of option holders. The Company used historical data to estimate the option exercise and employee departure behavior used in the lattice valuation model. Expected volatility is based on historical volatility of the Company's stock. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The Company considers all employees to have similar exercise behavior and therefore has not identified separate homogenous groups for valuation. The expected term of options granted is derived from the output of the option pricing model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual term of the options is based on the U.S. Treasury yields in effect at the time of grant.

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

Revenue from our business include the sale or license of Mediasite recorders and server software products and related services contracts, such as customer support, content hosting, equipment rental, and event services. We market our products principally to educational institutions, as well as corporations and government agencies that need to deploy, manage, index and distribute video content on Internet-based networks. We reach both our domestic and international markets through reseller networks, a direct sales effort and partnerships with system integrators.

*Q3-2008 compared to Q3-2007*

Revenue in Q3-2008 increased \$385 thousand, or 8% from Q3-2007 sales of \$4.70 million to \$5.09 million. Sales consisted of the following:

Product revenue totaled \$3.02 million in Q3-2008, which includes server software revenue of \$738 thousand and recorder revenue of \$2.28 million. Product revenue was impacted by a reserve for a potential stock rotation of \$200 thousand, in addition to volume and pricing variations indicated below.

	Q3-2008	Q3-2007
Units sold	246	213
Mobile to rack ratio	0.4 to 1	0.7 to 1
Recorder average sales price, excluding service (000 \$)	\$ 11.6	\$ 16.6
Server software revenue (000 \$)	\$ 738	\$ 879

Service revenue represents the portion of fees charged for Mediasite SmartServe customer support contracts amortized over the length of the contract, typically 12 months, as well as training, installation, rental, event and content hosting services. Service revenue increased from \$1.15 million in Q3-2007 to \$2.03 million in Q3-2008 primarily due to an increase in event and content hosting services as well as an increase in support contracts on new Mediasite recorders. At June 30, 2008, \$3.6 million of unrecognized support and service revenue remained in unearned revenue, of which we expect to realize \$1.4 million in the upcoming quarter.

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

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*YTD-2008 (Nine months) compared to YTD-2007 (Nine months)*

Revenue for YTD-2008 totaled \$11.5 million compared to YTD-2007 revenue of \$12.0 million. Revenue included the following:

\$6.1 million product revenue from the sale of 537 Mediasite recorders and server software versus \$9.03 million from the sale of 493 Mediasite recorders and server software in 2007.

\$5.3 million from Mediasite service plans, installation, training, rental, event and content hosting versus \$2.94 million in 2007.

**Gross Margin**

Total gross margins for Q3-2008 were \$3.8 million for a gross margin percentage of 74% compared to Q3-2007 of \$3.5 million or 74%. Total gross margins are comprised of product and services. Product gross margins decreased due to discount pricing related to an increase in higher volume transactions and end of life hardware upgrades. Gross margins were also negatively impacted by a decrease in the mix of server software licensing and an increase in the mix of billings from service contracts, which will be recognized over the life of the contract. The decrease in product gross margins was offset by the increase in service revenue which generally result in higher gross margins when they are ultimately recognized. The significant components of cost of revenue include:

Material and freight costs for Mediasite capture units of \$1.1 million in Q3-2008 compared to \$1.0 million in Q3-2007.

Due to the increasing significance of our services, the time devoted by internal staff to customer services has increased and we therefore allocate a percentage of staff salaries and wages to cost of revenue. Such costs were \$111 thousand in Q3-2008 and Q3-2007.

**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.

*Q3-2008 compared to Q3-2007*

Selling and marketing expenses decreased \$59 thousand or 2% from \$3.35 million in Q3-2007 to \$3.30 million in Q3-2008 resulting from:

Q3-2008 salaries, incentive compensation and benefits exceeded Q3-2007 by \$260 thousand primarily due to severance costs. Our selling and marketing staff decreased from 64 at June 30, 2007 to 60 at June 30, 2008.

Q3-2008 recruiting, travel, marketing, supplies, and facility expenses decreased \$276 thousand as a result of cost reduction efforts.

*YTD-2008 compared to YTD-2007*

Selling and marketing expenses increased \$1.3 million or 14% from \$8.9 million YTD-2007 to \$10.2 million YTD-2008 primarily as a result of staff increases. YTD increases in the major categories include:



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YTD-2008 salary, commissions, and benefits exceeded YTD-2007 by \$1.38 million due to higher staff levels through Q1-2008 and severance charges recorded in 2008. Staff levels were 64 at June 30, 2007, 73 at December 31, 2007, and 60 at June 30, 2008.

The Company initiated a plan in January 2008 to focus its selling and marketing efforts on the higher education market resulting in reductions, beginning in Q2-2008, to tradeshow and other marketing efforts focused on the corporate markets as well as a reduction in selling and marketing staff.

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As noted above, at June 30, 2008 we had 60 employees, excluding independent contractors and limited term employees, in Selling and Marketing compared to 64 employees at June 30, 2007. We reduced our headcount in selling and marketing in January 2008 from 73 and expect our headcount to remain at or near the current level for the remainder of fiscal 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.

#### *Q3-2008 compared to Q3-2007*

G&A expenses decreased \$422 thousand or 44% over the prior period from \$952 thousand in Q3-2007 to \$530 thousand in Q3-2008. Some significant variances between the periods include:

Salaries and benefits decreased \$291 thousand over the prior year due to a reduction in headcount and a decrease in incentive compensation.

During Q3-2008 we recorded a benefit of \$200 thousand due to the reversal of certain accruals in which payment is now deemed remote.

Professional services decreased by \$46 thousand primarily due to Sarbanes Oxley implementation costs in 2007.

#### *YTD-2008 compared to YTD-2007*

G&A decreased \$783 thousand or 26% from YTD-2007 to YTD-2008. As mentioned in the quarter discussion above, salaries, incentive compensation and benefits decreased over the prior year, resulting in a variance of \$410 thousand YTD. During YTD-2007, in response to growing revenue and customer accounts receivable, the Company increased the reserve for uncollectible accounts receivable and recorded a charge of \$50 thousand. Due to better collections and improved aging, the Company lowered the reserve and recorded a credit of \$130 thousand during YTD-2008. The \$200 thousand reduction in certain accruals also contributed to the decrease from 2007 results.

At June 30, 2008 we had 9 full-time employees in G&A compared to 14 as of June 30, 2007. We expect headcount to remain at or near current levels for the remainder of fiscal 2008.

### **Product Development Expenses**

Product development expenses (R&D expense) include salaries and wages of the software research and development staff and an allocation of benefits, facility and administrative expenses. Fluctuations in product development expenses correlate directly to changes in headcount.

#### *Q3-2008 compared to Q3-2007*

R&D expenses decreased \$59 thousand, or 7% from \$837 thousand in Q3-2007 to \$778 thousand in Q3-2008. Some significant differences between the periods consisted of:

Decreased salaries and benefits of \$21 thousand due to a reduction in headcount.

Decreased facilities expenses of \$38 thousand, resulting primarily from a lease termination.

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At June 30, 2008 we had 24 employees, excluding interns, in Research and Development compared to 26 at June 30, 2007. We expect headcount to remain at or near current levels for the remainder of fiscal 2008. We do not anticipate that any fiscal 2008 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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*YTD-2008 compared to YTD-2007*

YTD-2008 R&D expenses increased \$388 thousand, or 17% from YTD-2007. Increased salaries, incentive compensation and benefits during Q1 and Q2 2008 were the primary reason for the increase, accounting for \$224 thousand of the increase over the prior year. Increases in facilities related expenses of \$78 thousand accounted for the majority of the remaining increase.

**Other Income (Expense)**

Other income is comprised of interest income and interest expense. We are currently investing in certificates of deposit and overnight investment vehicles. Interest expense relates to our note payable and capital lease obligations.

**Liquidity and Capital Resources**

Cash used in operating activities was \$4.2 million in YTD-2008 compared to YTD-2007 of \$5.6 million an improvement of \$1.4 million or 25%. Cash used in 2008 was impacted by an increase in the net loss of \$1.7 million from \$4.9 million to \$6.6 million and offset by changes in working capital. Working capital changes included the positive effects of an increase in deferred revenue, reductions in accounts receivable and reductions in prepaid expenses and other current assets of \$461 thousand, \$948 thousand and \$272 thousand, respectively, and the negative effects of a \$115 thousand increase in inventories. YTD-2007 had negative effects of \$2.3 million and \$432 thousand, respectively, due to an increase in accounts receivable and increases in prepaid expenses and other current assets.

Cash used in investing activities was \$203 thousand in YTD-2008 compared to a use of \$397 thousand in YTD-2007 for the purchase of property and equipment.

Cash used in financing activities was \$269 thousand in YTD-2008 compared to cash provided of \$11.6 million in YTD-2007. In December 2006, we received \$10.4 million from the sale of common stock, net of issuance costs. There were no sales of common stock in YTD-2008. Cash used for payments on capital leases and note payable was \$298 thousand in YTD-2008 compared to \$63 thousand in YTD-2007.

The Company believes its cash position is adequate to accomplish its business plan through at least the next twelve months and therefore has no current plan to issue additional shares previously registered in its available shelf registration.

On May 2, 2007, the Company entered into a Loan and Security Agreement (the "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 Loan Agreement was modified on December 17, 2007 and March 31, 2008 and was amended and restated on June 16, 2008. 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 to support working capital needs, if the Company deems it advisable to do so. 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 \$598 thousand, all of which we expect to purchase over the next fiscal quarter, remain. This commitment is not recorded on the Company's Balance Sheet. The Company had approximately \$815 thousand of purchase commitments as of June 30, 2007.

**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.

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**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 June 30, 2008, a balance of \$638 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 June 30, 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, 2007 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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**ITEM 6. EXHIBITS**

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

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- 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)

August 8, 2008

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

August 8, 2008

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