SONIC FOUNDRY INC
Form 10-Q
February 08, 2008
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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 December 31, 2007

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 incorporation or organization)	**(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 x 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 x Non-accelerated filer ¨

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

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

Class	**Outstanding February 6, 2008**
Common Stock, $0.01 par value	35,570,836

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Sonic Foundry, Inc.

Consolidated Balance Sheets

(in thousands, except for share data)

(Unaudited)

	December 31, 2007	September 30, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 6,167	$ 8,008
Accounts receivable, net of allowances of $190 and $270	2,346	5,001
Inventories	664	204
Prepaid expenses and other current assets	724	975
Total current assets	9,901	14,188
Property and equipment:		
Leasehold improvements	975	975
Computer equipment	2,300	2,267
Furniture and fixtures	461	461
Total property and equipment	3,736	3,703
Less accumulated depreciation	1,688	1,520
Net property and equipment	2,048	2,183
Other assets:		
Goodwill and other intangibles, net of amortization of $1,659 and $1,656	7,607	7,610
Total assets	$ 19,556	$ 23,981
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 948	$ 1,512
Accrued liabilities	602	1,023
Unearned revenue	3,203	3,314
Current portion of notes payable	333	333
Current portion of capital lease obligation	63	66
Total current liabilities	5,149	6,248
Long-term portion of notes payable	473	556
Long-term portion of capital lease obligations	57	69
Other liabilities	325	348
Total liabilities	6,004	7,221
Stockholders equity:		
Preferred stock, $.01 par value, authorized 5,000,000 shares; none issued and outstanding		
5% preferred stock, Series B, voting, cumulative, convertible, $.01 par value (liquidation preference at par), authorized 10,000,000 shares, none issued and outstanding		

Common stock, $.01 par value, authorized 100,000,000 shares; 35,695,003 and 35,684,503 shares issued and 35,567,836 and 35,557,336 shares outstanding	357	357
Additional paid-in capital	183,860	183,528
Accumulated deficit	(170,470)	(166,930)
Receivable for common stock issued	(26)	(26)
Treasury stock, at cost, 127,167 shares	(169)	(169)
Total stockholders equity	13,552	16,760
Total liabilities and stockholders equity	$ 19,556	$ 23,981

See accompanying notes

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Sonic Foundry, Inc.

Consolidated Statements of Operations

(in thousands, except for per share data)

(Unaudited)

	Three Months Ended December 31, 2007	2006
Revenue:		
Product	$ 942	$ 2,586
Services	1,558	878
Other	20	9
Total revenue	2,520	3,473
Cost of revenue:		
Product	510	773
Services	112	
Total cost of revenue	622	773
Gross margin	1,898	2,700
Operating expenses:		
Selling and marketing	3,546	2,504
General and administrative	978	970
Product development	946	675
Total operating	5,470	4,149
Loss from operations	(3,572)	(1,449)
Other income, net	32	20
Net loss	$ (3,540)	$ (1,429)
Net loss per common share:		
basic and diluted	$ (0.10)	$ (0.04)
Weighted average common shares		
basic and diluted	35,561,814	32,362,612

See accompanying notes

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Sonic Foundry, Inc.

Consolidated Statements of Cash Flows

(in thousands)

(Unaudited)

	Three months ended December 31, 2007	2006
Operating activities		
Net loss	$ (3,540)	$ (1,429)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of other intangibles, and capitalized software development costs	3	53
Depreciation and amortization of property and equipment	167	156
Loss on sale of fixed assets	5	
Other non-cash items	48	(25)
Share-based compensation expense related to stock warrants and options	317	149
Provision for doubtful accounts	(80)	40
Changes in operating assets and liabilities:		
Accounts receivable	2,735	6
Inventories	(460)	92
Prepaid expenses and other current assets	167	24
Accounts payable and accrued liabilities	(985)	30
Other long-term liabilities	(23)	(23)
Unearned revenue	(75)	(88)
Net cash used in operating activities	(1,721)	(1,015)
Investing activities		
Purchases of property and equipment	(37)	(163)
Net cash used in investing activities	(37)	(163)
Financing activities		
Payments on notes payable	(83)	
Proceeds from issuance of common stock, net of issuance costs		10,491
Proceeds from issuance of common stock options	15	
Payments on capital leases	(15)	(10)
Net cash provided by (used in) financing activities	(83)	10,481
Net increase (decrease) in cash	(1,841)	9,303
Cash and cash equivalents at beginning of period	8,008	2,751
Cash and cash equivalents at end of period	$ 6,167	$ 12,054

See accompanying notes

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Sonic Foundry, Inc.

Notes to Consolidated Financial Statements

December 31, 2007

(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 month period ended December 31, 2007 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 product and Mediasite related products such as server software revenue.

Services

We sell support contracts to our Mediasite customers, typically one year in length and record the related revenue ratably over the contractual period. Our support contracts cover phone and electronic technical support availability over and above the level provided by our distributors, software upgrades, advance replacement and an extension of the standard hardware warranty from 90 days to one year. The manufacturer we contract with to build the units performs hardware warranty service. We also 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 deferred revenue until the revenue recognition criteria are met.

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Other

Other revenue consists of non-Mediasite related software licensing, custom software development performed under time and materials or fixed fee arrangements and shipping and handling. Software licensing is recorded when persuasive evidence of an arrangement exists, delivery occurs, the sales price is fixed or determinable and collectibility is reasonably assured. 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 not be able to recognize revenue until resellers sell the inventory to the final end user.

Shipping and Handling

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

Concentration of Credit Risk and Other Risks and Uncertainties

The Company s cash and cash equivalents are deposited with two major financial institutions. At times, deposits in these institutions exceed the amount of insurance provided on such deposits. The Company has not experienced any losses on such amounts and believes that it is not exposed to any significant risk on these balances.

We perform ongoing credit evaluations of our customers financial condition and generally do not require collateral. We maintain allowances for potential credit losses and such losses have been within our expectations.

Cash and Cash Equivalents

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

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Inventory Valuation

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

	12/31/07	9/30/07
Raw materials and supplies	$ 10	$ 10
Finished goods	654	194
	$ 664	$ 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. Each non-employee director, who was re-elected or who continued as a member of the board of directors on the annual meeting date and on each subsequent meeting of stockholders, was granted options to purchase 20 thousand shares of common stock.

Each option entitles the holder to purchase one share of common stock at the specified option price. The exercise price of each option granted under the plans was set at the 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 December 31, 2007, and 2006 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 December 31, 2007.

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

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

	Three months ended December 31, 2007	2006
Method	Lattice	Lattice
Expected life (years)	6.0 years	5.7 years
Risk-free interest rate	3.43%	4.67%
Expected volatility	63.08%	62.91%
Expected dividend yield	0%	0%

A summary of option activity as of December 31, 2007 and changes during the three 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	1,178,250	1.60	9.9	10,790
Exercised	(10,500)	1.37	7.1	420
Forfeited	(160,834)	2.47	2.3	2,477
Outstanding at December 31, 2007	5,719,238	2.24	6.6	991,054
Exercisable at December 31, 2007	3,843,783	$ 2.35	5.2	$ 958,511

A summary of the status of the Company s non-vested shares and changes during the three month periods ended December 31, 2007 and 2006 are presented below:

	2007		2006	
Non-vested Shares	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	1,178,250	0.88	323,000	1.96
Vested	(334,330)	1.11	(181,330)	0.86
Forfeited	(41,666)	1.16	(20,000)	1.04
Non-vested at December 31,	1,875,455	$ 1.13	1,246,184	$ 1.21

The weighted average grant date fair value of options granted during the three months ended December 31, 2007 was $0.88. As of December 31, 2007, there was $1.1 million of total unrecognized compensation cost related to non-vested share-based compensation, net of $399 thousand of estimated forfeitures. The cost is expected to be recognized over a weighted-average remaining life of 1.8 years.

Stock-based compensation recorded in the three month period ended December 31, 2007 of $271 thousand was allocated $172 thousand to selling and marketing expenses, $38 thousand to general and administrative expenses and $61 thousand to product development expenses. Cash received from option exercises under all stock option plans for the three month periods ended December 31, 2007 and 2006 was $15 thousand and $86 thousand, respectively. There were no tax benefits realized for tax deductions from option exercises in either of the three month periods ended December 31, 2007 and 2006. The Company currently expects to satisfy share-based awards with registered shares available to be issued.

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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 December 31, 2007	2006
Denominator		
Denominator for basic and diluted loss per share weighted average common shares	35,561,814	32,362,612
Securities outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive:		
Options and warrants	6,210,146	5,492,863

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. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. 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 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.

2. Related Party Transactions

During the three month periods ended December 31, 2007 and 2006, the Company paid fees of $63 thousand and $53 thousand to a law firm, a partner of which is a director and stockholder of the Company. The Company had accrued liabilities for unbilled services of $92 and $121 thousand for the periods ended December 31, 2007 and 2006 respectively, to the same law firm.

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During the three month periods ended December 31, 2007 and 2006, the Company recorded Mediasite product and customer support billings of $111 and $115 thousand, respectively, to MSKK, a Japanese reseller in which the Company has an equity interest.

As of December 31, 2007 and 2006, 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 $459 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 $686 thousand of purchase commitments as of December 31, 2006.

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 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 December 31, 2007 a balance of $806 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 December 31, 2007.

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 Agreement) with Silicon Valley Bank.

The Agreement, amount other things, a) removes a sub-limit of maximum indebtedness under the revolving line of credit of $1,000,000 prior to completion of a collateral audit; b) modifies 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)

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adjusts 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.

5. Income Taxes

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

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 December 31, 2007, and has not recognized any interest or penalties in the Statement of Operations for the first quarter of 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.

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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: 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. (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®, 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. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. 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.

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

Critical Accounting Policies

We have identified the following as critical accounting policies to our Company and have discussed the development, selection of estimates and the disclosure regarding them with the audit committee of the board of directors:

- Revenue recognition and allowance for doubtful accounts;
- Impairment of long-lived assets;
- Valuation allowance for net deferred tax assets; and
- Accounting for stock-based compensation.

Revenue Recognition and Allowance for Doubtful Accounts

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

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 not be able to recognize revenue until resellers sell the inventory to the final end user.

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

Impairment of long-lived assets

We assess the impairment of goodwill, 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.

Valuation allowance for net deferred tax assets

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

Accounting for stock based compensation

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized in the three month periods ended December 31, 2007 and 2006 includes the cost for all stock options granted prior to, but not yet vested as of October 1, 2006. This cost was based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. The cost for all share-based awards granted subsequent to September 30, 2005, represents the grant-date fair value that was estimated in accordance with the provisions of SFAS 123R. Results for prior periods have not been restated. Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period.

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

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Results of Continuing Operations

Revenue

Revenues from our business include the sale or license of Mediasite capture units and server software products and related services contracts, such as customer support, content hosting, equipment rental, and event services sold separately. 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.

Q1-2008 compared to Q1-2007

Revenues in Q1-2008 decreased $953 thousand, or 27% from Q1-2007 sales of $3.5 million to $2.5 million. Revenues have historically been seasonally weaker in Q1 as our core higher education market typically purchases at a faster rate in the third and fourth fiscal quarters. Q1-2008 results additionally reflected lagging sales to corporate customers as a result of slowing economic conditions as well as delayed sales to the education market in anticipation of new product updates being released in Q2-2008. Sales consisted of the following:

Product revenue from sale of Mediasite capture units

	Q1-2008	Q1-2007
Units sold	82	132
Mobile to rack ratio	1.0 to 1	1.4 to 1
Average sales price, excluding service (000 s)	$ 11.5	$ 19.6
Product gross margin	46%	74%

Services revenue represents the portion of fees charged for Mediasite SmartServe customer support contracts amortized over the length of the contract, typically 12 months, as well as training, installation, rental, event and content hosting services. Services revenue increased from $878 thousand in Q1-2007 to $1.6 million in Q1-2008 primarily due to an increase in event and content hosing services as well as an increase in support contracts on new Mediasite capture units and as renewals of support contracts entered into in prior years. At December 31, 2007 $3.2 million of unrecognized support and service revenue remained in unearned revenues, of which we expect to realize $1.4 million in the upcoming quarter.

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

Gross Margin

Total gross margins for Q1-2008 were $1.9 million for a gross margin percentage of 75% compared to Q1-2007 of $2.7 million or 78%. The significant components of cost of revenue include:

Material and freight costs for Mediasite capture units of $658 thousand in Q1-2007 compared to $450 thousand in Q1-2008.

Labor and related costs of $62 thousand in Q1-2007 compared to $59 thousand in Q1-2008.

Due to the increasing significance of our services, the time devoted by internal staff to customer services has increased and we therefore began allocating a percentage of staff salaries and wages to cost of revenues in Q2-2007. Such costs were $112 thousand in Q1-2008.

Amortization of Mediasite acquisition amounts assigned to purchased technology and other identified intangibles of $53 thousand in Q1-2007. Such amounts were fully amortized in Q1-2007. There were no such amounts in Q1-2008.

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Operating Expenses

Selling and Marketing Expenses

Selling and marketing expenses include wages and commissions for sales, marketing, business development and technical support personnel, print advertising and various promotional expenses for our products. Timing of these costs may vary greatly depending on introduction of new products and services or entrance into new markets, or participation in major tradeshows.

Q1-2008 compared to Q1-2007

Selling and marketing expenses increased $1.0 million or 42% from $2.5 million in Q1-2007 to $3.5 million in Q1-2008 resulting from:

Q1-2008 salaries, incentive compensation and benefits exceeded Q1-2007 by $786 thousand due to the growth in our sales staff. Our sales staff increased from 49 at December 31, 2006 to 73 at December 31, 2007.

Q1-2008 recruiting, travel, and facility expenses increased $209 thousand as a result of increases to selling and marketing staff.

As of December 31, 2007 we had 73 employees, excluding independent contractors and limited term employees, in Selling and Marketing compared to 49 employees at December 31, 2006. We reduced our headcount in selling and marketing in January 2008 by approximately 15% and expect our headcount to remain at that 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.

Q1-2008 compared to Q1-2007

G&A expenses increased $8 thousand or 1% over the prior period from $970 thousand in Q1-2007 to $978 thousand in Q1-2007. Some significant variances between the periods include:

Salaries and benefits increased $163 thousand over the prior year, due in part to SFAS 123R expense. This increase was partially offset by a corresponding decrease of $53 thousand in incentive compensation.

In response to decreased customer accounts receivable and improved aging, the Company lowered the reserve for uncollectible accounts receivable and recorded a credit of $80 thousand in Q1-2008.

As of December 31, 2007 we had 16 employees in G&A compared to 10 as of December 31, 2006. We anticipate G&A headcount to remain at this level for the remainder of the fiscal year.

Product Development Expenses

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

Q1-2008 compared to Q1-2007

R&D expenses increased $271 thousand, or 40% from $675 thousand in Q1-2007 to $946 thousand in Q1-2008. Some significant differences between the periods include:

Increased salaries and benefits of $177 thousand.

Increased share of facilities expenses of $54 thousand.

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As of December 31, 2007 we had 26 employees, excluding interns, in Research and Development compared to 18 at December 31, 2006. We anticipate R&D headcount to remain flat during 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.

Other Income

Other income is primarily interest income. We are currently investing in certificates of deposit and overnight investment vehicles.

Liquidity and Capital Resources

Cash used in operating activities was $1.7 million in Q1-2008 compared to Q1-2007 of $1.0 million an increase of $700 thousand or 69%. Cash used in 2008 was impacted by an increase in the net loss of $2.1 million from $1.4 million to $3.5 million and partially offset by changes in working capital. Working capital changes included the positive effects of reductions in accounts receivable and prepaid expenses and other current assets of $2.7 million and $167 thousand, respectively, and the negative effects of a $1.0 million decrease in accounts payable and accrued liabilities and a $460 thousand increase in inventory. Q1-2007 had more modest changes in working capital components with a $92 thousand decrease in inventory and a $30 thousand increase in accounts payable and accrued liabilities.

Cash used in investing activities was $37 thousand in Q1-2008 compared to a use of $163 thousand in Q1-2007 for the purchase of property and equipment.

Cash used in financing activities was $83 thousand in Q1-2008 compared to cash provided of $10.5 million in Q1-2007. In December 2006, we received $10.5 million from the sale of common stock, net of issuance costs. There were no sales of common stock in Q1-2008. Cash used for payments on capital leases and note payable was $98 thousand in Q1-2008 compared to $10 thousand in Q1-2007.

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. 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 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 $459 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 $686 thousand of purchase commitments as of December 31, 2006.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Derivative Financial Instruments

The Company is not party to any derivative financial instruments or other financial instruments for which the fair value disclosure would be required under SFAS No. 133, Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments. The Company s cash equivalents consist of overnight investments in money market funds that are carried at fair value. Accordingly, we believe that the market risk of such investments is minimal.

Interest Rate Risk

The Company s cash equivalents are subject to interest rate fluctuations; however, we believe this risk is immaterial due to the short-term nature of these investments.

The interest rate under our revolving line of credit and term loan is subject to change based on the Silicon Valley Bank s Prime Rate. At December 31, 2007 a balance of $806 thousand was outstanding on the term loan and there was no outstanding balance on the revolving line of credit.

Foreign Currency Exchange Rate Risk

All international sales of our products are denominated in US dollars.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Based on evaluations at December 31, 2007, 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

ITEM 6. EXHIBITS

NUMBER	DESCRIPTION
3.1	Amended and Restated Articles of Incorporation of the Registrant, filed as Exhibit No. 3.1 to the registration statement on amendment No. 2 to Form SB-2 dated April 3, 1998 (Reg. No. 333-46005) (the Registration Statement), and hereby incorporated by reference.
3.2	Amended and Restated By-Laws of the Registrant, filed as Exhibit No. 3.1 to Form 8-K filed on December 19, 2007, and hereby incorporated by reference.
10.1*	Registrant s 1995 Stock Option Plan, as amended, filed as Exhibit No. 4.1 to the Registration Statement on Form S-8 on September 8, 2000, and hereby incorporated by reference.
10.2*	Employment Agreement between Registrant and Rimas Buinevicius dated as of January 1, 2001, filed as Exhibit 10.4 to the Quarterly Report on Form 10-Q for the quarter ended December 31, 2000, and hereby incorporated by reference.

10.3*	Employment Agreement between Registrant and Monty R. Schmidt dated as of January 1, 2001, filed as Exhibit 10.5 to the Quarterly Report on Form 10-Q for the quarter ended December 31, 2000, and hereby incorporated by reference.
10.4*	Registrant s Amended 1999 Non-Qualified Plan, filed as Exhibit 4.1 to Form S-8 on December 21, 2001, and hereby incorporated by reference.
10.5	Commercial Lease between West Washington Associates LLC and Sonic Foundry, Inc. regarding 222 West Washington Ave., Suite 775, Madison, WI, dated August 1, 2003 filed as Exhibit 10.21 to Form 10-K filed on December 23, 2003 and hereby incorporated by reference.

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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.

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.

31.1 Section 302 Certification of Chief Executive Officer

31.2 Section 302 Certification of Chief Financial Officer

32 Section 906 Certification of Chief Executive Officer and Chief Financial Officer

Registrant will furnish upon request to the Securities and Exchange Commission a copy of all exhibits, annexes and schedules attached to each contract referenced in item 10.

* Compensatory Plan or Arrangement

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SIGNATURES

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

Sonic Foundry, Inc.

(Registrant)

February 8, 2008	By:	/s/ Rimas P. Buinevicius Rimas P. Buinevicius Chairman and Chief Executive Officer
February 8, 2008	By:	/s/ Kenneth A. Minor Kenneth A. Minor Chief Accounting and Financial Officer and Secretary

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