sonicfoundry


# 2005 annual report

# Your knowledge is power. Seize it.

How much would your organization's effectiveness improve if you could easily process, transfer and reuse the important knowledge that is developed every day? We make the right tools for communicating and preserving the most vital asset you have - organizational know-how.

Our integrated webcasting and web presentation solutions are trusted by Fortune 500 companies, education institutions and government agencies for a variety of critical communication needs.

# Chairman's Letter

**The need to communicate** hasn't changed much over the last 100 years. What has changed are the economics of communication and the ready availability of the technology to do so. More people than ever are discovering and taking advantage of new ways to be seen and heard. Whether it's a two person conversation, a blog or a webcast to thousands, the key elements of a message have tended to stay the same, but the techniques and the distribution methods continue to evolve. Today's systems allow for a tighter message to be delivered to more specific audience segments. The sea change we are witnessing today is a fundamental shift from mainstream media, network television, radio, newspapers, magazines and film to a communications world that is driven by better defined audience reach.

This significant shift fundamentally defines Sonic Foundry, the company you have invested in, and continually impacts what we offer to the market. Today's opportunity is called *rich media communications* and it's where we have positioned the company for what we feel will be a long term growth trend that continues to change the way individuals and organizations communicate.

Over the last 3 years, we evangelized our Mediasite product line as a new form of communication technology geared specifically to information providers. We've found that whether it's the professor, CEO, reporter, health care provider, product manager, lawyer or engineer, they all have one thing in common: a fundamental need to share knowledge and information with those that seek it. What makes us unique is our ability to borrow the early ideas of television, telephony and audio/video production and meld them into an entirely new form of communication that is changing the way people deliver their message.

*"This is still just the beginning of what we expect will turn into thousands of devices capturing and transmitting information for millions of hours of content, all accessible on a distributed network basis."*

2005 marked further developments that firmly established Mediasite as a *platform*. The advances we've made are not unlike the development of the first radio or television transmitter. The Mediasite platform is a prerequisite to allowing the rich media communications process to begin. And similar to the radio and television market, we are now seeing the "sets" evolve economically in a wide variety of devices, namely PCs, tablets, PDAs, cellphones, etc. Thus, recognition of this new communication medium is increasing and viewership is rising, not unlike the dawn of radio and television.

And similar to the rise in viewership, we will also see a spread of "networks" like we've never seen before. In 2005 we introduced a new search portal, Mediasite.com, a website that aggregates public presentations created with Mediasite systems in one location, allowing users to search specific content with a simple search phrase. Through our advanced R&D group, we incorporated unique ways in which data can be indexed and therefore searched. Users are now able to drill down into very deep and technical subject matter that is difficult to find, even through the use of traditional search engines like Google, Yahoo or MSN.

Through the power of the Mediasite platform, we have an opportunity to create thousands of networks who provide their own customized content delivered to their very specific audience clusters. We are now offering the elements of Mediasite.com and the server technology that brings it all together to organizations designed to transmit communications and have relevant audience reach.

Three years ago we were proud of signing our first five customers.  Today they number over 400.  In early 2003, we documented the capture of a few dozen rich media presentations.  Today, there are thousands of hours of Mediasite content created for both public and private consumption.  This is still just the beginning of what we expect will turn into thousands of devices capturing and transmitting information for millions of hours of content, all accessible on a distributed network basis.

And this is precisely why we have entered the most exciting time of our market development process.  The horseless carriage is now an automobile, it's moved from the machine shop and into full blown factory production. And now our market is appreciating the power of the technology we have unleashed.

Market patience is one of the key advantages that we've been able to maintain.   Over the years, we've ridden out the various market ups and downs and are now at the beginning stages of market acceptance and maturation for yet another technology wave.  Through it all, we've maintained a market lead in concept and development and are now well positioned to take advantage of the anticipated market growth.  As shareholders, I'm delighted you have entrusted us with building this dream and continuing the ride.

Rimas P. Buinevicius
Chairman and Chief Executive Officer
Madison, WI
February 2006

**SONIC FOUNDRY, INC.**
**222 West Washington Avenue**
**Madison, Wisconsin 53703**

**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS**
**To Be Held March 15, 2006**

The Annual Meeting of Stockholders of **SONIC FOUNDRY, INC**., a Maryland corporation ("Sonic") will be held at the Monona Terrace Community and Convention Center, One John Nolen Drive, Madison, Wisconsin 53703 on March 15, 2006 at 9:00 a.m. local time, for the following purposes:

1. To elect one director to hold office for a term of five years, and until his successor is duly elected and qualified.

2. To ratify the appointment of Grant Thornton LLP as our independent auditors for the fiscal year ending September 30, 2006.

3. To transact such other business as may properly come before the meeting or any adjournments thereof.

All the above matters are more fully described in the accompanying Proxy Statement.

Only holders of record of Common Stock at the close of business on January 17, 2006 are entitled to notice of, and to vote at, this meeting or any adjournment or adjournments thereof.

Please complete and return the enclosed proxy in the envelope provided or follow the instructions on the proxy card to authorize a proxy by telephone or over the Internet, **whether or not** you intend to be present at the meeting in person.

By Order of the Board of Directors,

Kenneth A. Minor

Kenneth A. Minor
Secretary

Madison, Wisconsin
January 23, 2006

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**If you cannot personally attend the meeting, it is earnestly requested that you promptly indicate your vote on the issues included on the enclosed proxy and date, sign and mail it in the enclosed self-addressed envelope, which requires no postage if mailed in the United States or, follow the instructions on the proxy card to authorize a proxy by telephone or over the Internet. Doing so will save us the expense of further mailings. If you sign and return your proxy card without marking choices, your shares will be voted in accordance with the recommendations of the Board of Directors.**

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**SONIC FOUNDRY, INC.**
**222 W. Washington Avenue**
**Madison, Wisconsin 53703**

January 23, 2006

# PROXY STATEMENT

The Board of Directors of Sonic Foundry, Inc., a Maryland corporation ("Sonic"), hereby solicits the enclosed proxy. Unless instructed to the contrary on the proxy, it is the intention of the persons named in the proxy to vote the proxies:

**FOR** the election of Frederick H. Kopko, Jr. as Director for term expiring in 2011; and

**FOR** the ratification of the appointment of Grant Thornton LLP as independent auditors of Sonic for the fiscal year ending September 30, 2006.

In the event that the nominee for director becomes unavailable to serve, which management does not anticipate, the persons named in the proxy reserve full discretion to vote for any other person who may be nominated. Proxies may also be authorized by telephone or over the Internet by following the instructions on the proxy card. Any stockholder giving a proxy may revoke the same at any time prior to the voting of such proxy. This Proxy Statement and the accompanying proxy are being mailed on or about February 8, 2006.

Each stockholder will be entitled to one vote for each share of Common Stock standing in his or her name on our books at the close of business on January 17, 2006 (the "Record Date"). On that date, we had outstanding and entitled to vote 31,616,577 shares of Common Stock.

## QUORUM; VOTES REQUIRED

As of the Record Date, there were 31,616,577 shares of Common Stock outstanding and entitled to vote. Each share of outstanding Common Stock entitles the holder thereof to one vote. Votes cast by proxy or in person at the Annual Meeting will be tabulated by the inspector of elections appointed for the Annual Meeting and will determine whether or not a quorum is present. Where, as to any matter submitted to the stockholders for a vote, proxies are marked as abstentions (or stockholders appear in person but abstain from voting), such abstentions will be treated as shares that are present and entitled to vote for purposes of determining the presence of a quorum but as unvoted for purposes of determining the approval of any matter submitted to the stockholders for a vote. If a broker indicates on the proxy that it does not have discretionary authority as to certain shares to vote on a particular matter and has not received instructions from the beneficial owner, which is known as a broker non-vote, those shares will not be considered as present and entitled to vote with respect to that matter; however, such shares will be considered present for purposes of a quorum. A majority of the shares of Common Stock issued, outstanding and entitled to vote at the Annual Meeting, present in person or represented by proxy, shall constitute a quorum at the Annual Meeting.

The election of the Directors requires a plurality of the votes present and entitled to vote. The approval of each other proposal requires the affirmative vote of the holders of a majority of the votes cast at the Annual Meeting.

## DATE, TIME AND PLACE OF ANNUAL MEETING

The Annual Meeting will be held on March 15, 2006 at 9:00 a.m. (Central time) at the Monona Terrace Community and Convention Center, One John Nolen Drive, Madison, Wisconsin 53703.

RECORD DATE; STOCKHOLDERS ENTITLED TO VOTE

Only holders of issued and outstanding shares of Sonic's common stock as of the close of business on January 17, 2006 are entitled to notice of and to vote at the Annual Meeting, including any adjournment or postponement thereof. As of that date, there were 31,616,577 shares of Sonic's common stock outstanding, held by approximately 8,800 shareholders, of which approximately 8,300 were held in "street name". The presence, in person or by proxy, at the Annual Meeting of the holders of a majority of the outstanding shares of our common stock is necessary to constitute a quorum at the Annual Meeting.

## PROPOSAL ONE: ELECTION OF DIRECTOR

Our Amended and Restated Articles of Incorporation and Bylaws provide that the Board of Directors shall be divided into five classes, with each class having a five-year term. Directors are assigned to each class in accordance with a resolution or resolutions adopted by the Board of Directors, each class consisting, as nearly as possible, of one-fifth the total number of directors. Vacancies on the Board of Directors resulting from death, resignation, disqualification, removal or other causes may be filled by either the affirmative vote of the holders of a majority of the then-outstanding shares or by the affirmative vote of a majority of the remaining directors then in office, even if less than a quorum of the Board of the Directors. Newly created directorships resulting from any increase in the number of directors may, unless the Board of Directors determines otherwise, be filled only by the affirmative vote of the directors then in office, even if less than a quorum of the Board of Directors. A director elected by the Board of Directors to fill a vacancy (including a vacancy created by an increase in the number of directors) shall serve for the remainder of the full term of the class of directors in which the vacancy occurred and until such director's successor is elected and qualified.

Our Amended and Restated Articles of Incorporation provide that the number of directors, which shall constitute the whole Board of Directors, shall be fixed exclusively by one or more resolutions adopted from time to time by the Board of Directors. Our currently authorized number of directors is seven. The seat on the Board of Directors, currently held by Frederick H. Kopko, Jr., is designated a Class III Board seat, with a term expiring as of the Annual Meeting. Mr. Kopko will stand for re-election at this Annual Meeting.

Mr. Kopko is currently a Board member of Sonic who was previously elected by the stockholders. If elected at the Annual Meeting, Mr. Kopko would serve until the 2011 Annual Meeting and until his successor is elected and qualified or until his earlier death, resignation or removal.

**Nominee for Director for a Five-Year term expiring on the 2011 Annual Meeting**

**Frederick H. Kopko, Jr.**

Mr. Kopko, age 50, has been our Secretary from April 1997 to February 2001 and has been a Director since December 1995. Mr. Kopko is a partner of the law firm of McBreen & Kopko, Chicago, Illinois, and has been a partner of that firm since January 1990. He has been a Director of Mercury Air Group, Inc. since 1992. Mr. Kopko received a B.A. degree in economics from the University of Connecticut, a J.D. degree from the University of Notre Dame Law School, and an M.B.A. degree from the University of Chicago.

The election of a Director requires the approval of a plurality of the votes cast by holders of the shares of Sonic's common stock. Any shares not voted, whether by broker non-vote or otherwise, will have no impact on the outcome of the election.

**The Board of Directors unanimously recommends a vote FOR the election of Mr. Kopko as Class III Director.**

## DIRECTORS CONTINUING IN OFFICE

**Rimas P. Buinevicius** **Term Expires 2007**

Mr. Buinevicius, age 43, has been our Chairman of the Board since October 1997 and Chief Executive Officer since January 1997. In addition to his organizational duties, Mr. Buinevicius is a recognized figure in the rich media industry focused on the convergence of technology, digital media and entertainment. Mr. Buinevicius joined Sonic in 1994 as General Manager and Director of Marketing. Prior to joining Sonic, Mr. Buinevicius spent the majority of his professional career in the fields of biomedical and industrial control research and development. Mr. Buinevicius earned an M.B.A. degree from the University of Chicago; a Master's degree in Electrical Engineering from the University of Wisconsin, Madison; a Bachelor's degree in Electrical Engineering from the Illinois Institute of Technology, Chicago; and is a recipient of Ernst and Young's Entrepreneur of the Year award.

**Monty R. Schmidt** **Term Expires in 2008**

Mr. Schmidt, age 41, has been our Chief Technology Officer since July 2003 and served as President from March 1994 to July 2003 and as a Director since February 1994. Throughout his tenure at Sonic Foundry, Mr. Schmidt has spearheaded a variety of engineering and strategic initiatives that have helped grow Sonic from the one person startup he founded in 1991. In addition to acting as an industry liaison, Mr. Schmidt is responsible for managing and facilitating technology development and utilization. Prior to joining Sonic, Mr. Schmidt served in software and hardware engineering capacities for companies in the medical and food service equipment industries. Mr. Schmidt has a B.S. degree in Electrical Engineering from the University of Wisconsin, Madison.

**Gary R. Weis** **Term Expires in 2008**

Mr. Weis, age 58, has been a Director of Sonic since February 2004 and was President, Chief Executive Officer and a Director of Cometa Networks, a wireless broadband Internet access company from March 2003 to April 2004. From May 1999 to February 2003 he was Senior Vice President of Global Services at AT&T where he was responsible for one of the world's largest data and IP networks, serving more than 30,000 businesses and providing Internet access to more than one million individuals worldwide. While at AT&T, Mr. Weis also was CEO of Concert, a joint venture between AT&T and British Telecom. Previously, from January 1995 to May 1999 he was General Manager of IBM Global Services, Network Services. Mr. Weis served as a Director from March 2001 to February 2003 of AT&T Latin America, a facilities-based provider of telecom services in Brazil, Argentina, Chile, Peru and Columbia. Mr. Weis earned BS and MS degrees in Applied Mathematics and Computer Science at the University of Illinois, Chicago.

**David C. Kleinman** **Term Expires in 2009**

Mr. Kleinman, age 70, has been a Director of Sonic since December 1997 and has taught at the Graduate School of Business at the University of Chicago since 1971, where he is now Adjunct Professor of Strategic Management. Mr. Kleinman has been a Director (trustee) of the Acorn Funds since 1972 (of which he is also Chair of the Audit Committee, Chair of the Committee on Investment Performance and a member of the Committee on the Investment Advisory Agreement); a Director since 1984 of the Irex Corporation, a contractor and distributor of insulation materials (where he is Lead Director of the Board of Directors); and a Director since 1993 of Plymouth Tube Company, a manufacturer of metal tubing and metal extrusions (where he serves on the Audit Committee). He is currently a member of the Advisory Board of DSC Logistics, a logistics management and warehousing firm. From May 1997 to February 2004, Mr. Kleinman served as a Director of AT&T Latin America and predecessor companies, a facilities-based provider of telecom services in Brazil, Argentina, Chile, Peru and Columbia (where he was chair of the Audit Committee and a member of the Compensation Committee). From 1994 to 2005, he was a director of Wisconsin Paper and Products Company, a jobber of paper and paper products. From 1964 to 1971, Mr. Kleinman was a member of the finance staff of the Ford Motor Company.

**Paul S. Peercy** **Term Expires in 2009**

Mr. Peercy, age 65, has been a Director of Sonic since February 2004. Since September 1999, Mr. Peercy has served as dean of the University of Wisconsin-Madison College of Engineering. Since 2001 Mr. Peercy has been a member of the National Academy of Engineering. In 2000, then-Wisconsin Governor Tommy Thompson named Mr. Peercy to the Wisconsin Technology and Entrepreneurship Council. From August 1995 to September 1999, Mr. Peercy served as president of SEMI/SEMATECH, an Austin, Texas-based non-profit consortium of more than 160 of the nation's suppliers to the semiconductor industry. Prior to that position he was director of Microelectronics and Photonics at Sandia National Laboratories in Albuquerque, New Mexico. He is the author or co-author of more than 175 technical papers and the recipient of two patents. Mr. Peercy received a BA degree in Physics from Berea College and MS and PhD degrees in Physics from the University of Wisconsin - Madison.

**Arnold B. Pollard** **Term Expires in 2010**

Mr. Pollard, age 63, has been a Director of Sonic since December 1997. From 1993 until January 2002, he was the President and Chief Executive Officer of Chief Executive Group, which published "Chief Executive" magazine. For over 25 years, he has been President of Decision Associates, a management consulting firm specializing in organizational strategy and structure. Mr. Pollard has served as a Director of Firebrand Financial Group, an investment banking, brokerage, and asset management firm, since 1996, as a Director and a member of the compensation committee of Delta Financial Corporation, a public company engaged in the business of home mortgage lending, since 2005 as a Director of Sentigen Holding Corp, a public company engaged in the biotechnology industry and since 1996 as a Director of the International Management Education Foundation, a non-profit educational organization. He also serves on the advisory board of PeopleTrends. From 1989 to 1991, Mr. Pollard served as Chairman and Chief Executive Officer of Biopool International, a biodiagnostic public company focusing on blood related testing; and previously served on the boards of Lillian Vernon Corp. and DEBE Systems Corp. From 1970 to 1973, Mr. Pollard served as adjunct professor at the Columbia Graduate School of Business. Mr. Pollard graduated from Cornell University (Tau Beta Pi), and holds a doctorate in Engineering-Economics Systems from Stanford University.

## MEETINGS AND COMMITTEES OF DIRECTORS

The Board of Directors met four times during the fiscal year ended September 30, 2005 ("Fiscal 2005"). The Board of Directors has reviewed the independence of each director under the listing standards of the National Association of Securities Dealers. Based upon its review, the Board has determined that, of the seven directors who, if elected, will serve on the Board after the annual stockholders meeting, Messrs. Kleinman, Peercy, Weis and Pollard are "independent" as defined under Nasdaq listing standards.

The Board of Directors has four standing committees, the Audit Committee, the Executive Compensation Committee, the Nominating Committee and the Strategy Committee.

Sonic has a standing audit committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Messrs. Kleinman (chair), Weis and Peercy serve on the Audit Committee. Sonic's Board of Directors has determined that all members of Sonic's Audit Committee are "independent" as that term is used in Item 7(d)(3)(iv) of Schedule 14A under the Exchange Act and as defined under Nasdaq listing standards. The Audit Committee provides assistance to the Board in fulfilling its oversight responsibility including: (i) internal and external financial reporting, (ii) risks and controls related to financial reporting, and (iii) the internal and external audit process. The Audit Committee is also responsible for recommending to the Board the selection of our independent public accountants and for reviewing all related party transactions. The Audit Committee met six times in Fiscal 2005. A copy of the charter of the Audit Committee is available on Sonic's website.

Sonic's Board of Directors has determined that, due to his affiliation with the Graduate School of Business at the University of Chicago, and due to his serving as a director on numerous company boards, along with his other academic and business credentials, Mr. Kleinman has the requisite experience and applicable background to meet Nasdaq standards requiring financial sophistication of at least one member of the audit committee. Sonic's Board of Directors has also determined that neither Mr. Kleinman nor any other member of the Audit Committee is an audit committee financial expert as defined by applicable SEC regulations. Sonic may choose to recruit one or more directors that satisfy the current requirements for an audit committee financial expert; however, Sonic has not yet identified an individual satisfying those criteria as well as other criteria that Sonic believes are important for an individual to make a meaningful contribution to the deliberations of the Board of Directors as a whole. There can be no assurance when, or if, Sonic will identify such an individual in the foreseeable future.

The Executive Compensation Committee consists of Messrs. Kleinman (chair), Pollard and Peercy. The Board of Directors has determined that all of the members are “independent” as defined under Nasdaq listing standards. The Executive Compensation Committee makes recommendations to the Board with respect to salaries of employees, the amount and allocation of any incentive bonuses among the employees, and the amount and terms of stock options to be granted to executive officers. The Committee is also responsible for establishing objective, as well as subjective goals and certifying such goals as having been met. The Executive Compensation Committee met three times in Fiscal 2005. A copy of the charter of the Executive Compensation Committee is available on Sonic’s website.

The Nominating Committee consists of Messrs. Pollard (chair) and Kleinman. The Board of Directors has determined that all of the members are “independent” as defined under Nasdaq listing standards. The purpose of the Nominating Committee is to evaluate and recommend candidates for election as directors, make recommendations concerning the size and composition of the Board of Directors, develop specific criteria for director independence, and assess the effectiveness of the Board of Directors. Our Board of Directors has adopted a charter for the Nominating Committee, which is available on Sonic’s website. The Nominating Committee will review all candidates in the same manner regardless of the source of the recommendation. Shareholder recommendations of candidates for Board membership will be considered when submitted with sufficient detail including the candidate’s name, principal occupation during the past 5 years, listing of directorships, a statement that such nominee has consented to the submission of the nomination, amount of common stock of Sonic held by the nominee and qualification addressed to:

Corporate Secretary
Sonic Foundry, Inc.
222 W. Washington Ave., Suite 775
Madison, WI 53703

The Strategy Committee consists of Messrs. Pollard (chair), Buinevicius and Schmidt. The Strategy Committee meets regularly with senior management, an outside advisory board and other industry experts in order to develop and refine Sonic’s business strategy. The Strategy Committee met in person eight times and held numerous telephonic meetings in fiscal 2005. Immediately following the 2006 Annual Meeting, the Strategy Committee will consist of Messrs. Pollard (chair) and Buinevicius.

Each member of the Board attended at least 75% of the aggregate of the meetings of the Board and of the Committees on which he served and held during the period for which he was a Board or Committee member, respectively. Directors are expected to attend the Annual Meeting of Stockholders, and all directors attended the 2005 Annual Meeting.

**DIRECTORS COMPENSATION**

Our directors, who are not also our full-time employees, receive a fee of $1,500 for attendance at each meeting of the Board of Directors and $850 per committee meeting attended, other than the chair of our Audit committee, Mr. Kleinman, who receives $2,000 per Audit Committee meeting attended. In addition, the chair of our strategy committee receives compensation of $5,000 per month totaling $60,000 in 2005 for his role in managing the activities of the strategy committee. The cash compensation paid to the five non- employee directors combined in Fiscal 2005 was $119,650. When traveling from out-of-town, the members of the Board of Directors are also eligible for reimbursement for their travel expenses incurred in connection with attendance at Board meetings and Board Committee meetings. Directors who are also employees do not receive any compensation for their participation in Board or Board Committee meetings.

Pursuant to the Non-Employee Directors' Stock Option Plan, we grant to each non-employee director who is reelected or who is continuing as a member of the Board of Directors at each annual stockholders meeting a stock option to purchase 20,000 shares of Common Stock. Further, the chair of our Audit Committee receives an additional stock option grant to purchase 5,000 shares of Common Stock per year pursuant to Sonic's Non Qualified Stock Option Plan. The exercise price of each stock option is equal to the market price of Common Stock on the date the stock option is granted. Stock options issued under the Non-Employee Directors' Stock Option Plan generally will vest fully on the first anniversary of the date of grant and expire after ten years. An aggregate of 900,000 shares are reserved for issuance under the Non-Employee Directors' Stock Option Plan. In addition, Mr. Pollard was granted an option to purchase 76,000 shares of Common Stock under Sonic's Non Qualified Stock Option Plan and cash compensation of $30,000 in February 2005 and was granted an option to purchase 94,000 shares of Common Stock under Sonic's Non Qualified Stock Option Plan in December 2005 and cash compensation of $55,000 in January 2006 for business advisory services.

If any change is made in the stock subject to the Non-Employee Directors Stock Option Plan, or subject to any option granted thereunder, the Non-Employee Directors Stock Option Plan and options outstanding thereunder will be appropriately adjusted as to the type(s), number of securities and price per share of stock subject to such outstanding options.

The options and warrants set forth above have an exercise price equal to the fair market value of the underlying common stock on the date of grant. The term of all such options is ten years.

## PROPOSAL TWO: RATIFICATION OF APPOINTMENT OF INDEPENDENT AUDITORS

The Board of Directors, upon the recommendation of the Audit Committee, has appointed the firm of Grant Thornton LLP ("GT") as independent auditors to audit our financial statements for the year ending September 30, 2006, and has further directed that management submit the selection of independent public accountants for certification by the stockholders at the annual meeting. GT was appointed our independent public accountants and Ernst & Young LLP ("EY") was dismissed in July 2004 upon approval of the Audit Committee on July 9, 2004. Representatives of GT are expected to be present at the annual meeting to respond to stockholders' questions and to have the opportunity to make any statements they consider appropriate.

Stockholder ratification of the selection of GT as our independent auditors is not required by our Bylaws or otherwise. However, the Board is submitting the selection of GT to the stockholders for ratification as a matter of good corporate practice. If the stockholders fail to ratify the selection, the Board and the Audit Committee will reconsider whether or not to retain that firm. Even if the selection is ratified, the Board and the Audit Committee in their discretion may direct the appointment of a different independent accounting firm at any time during the year if they determine that such a change would be in the best interests of Sonic and its stockholders.

The ratification of the appointment of GT as independent public accountants requires the approval of a majority of the votes cast by holders of our shares. Shares may be voted for or withheld from this matter. Shares that are withheld and broker non-votes will have no effect on this matter because ratification of the appointment of GT requires a majority of the shares cast.

**Recommendation of Board of Directors**

**THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR PROPOSAL 2 RATIFYING THE APPOINTMENT OF GT AS INDEPENDENT AUDITORS FOR SONIC.**

**Relations with Independent Auditors**

GT has served as our independent public accountants since its appointment in July 2004. As stated in Proposal 2, the Board has selected GT to serve as our independent auditors for the fiscal year ending September 30, 2006.

Audit services performed by GT for fiscal years 2005 and 2004 consisted of the examination of our financial statements, review of quarter fiscal results, and services related to filings with the Securities and Exchange Commission (SEC). Audit services performed by EY for fiscal 2004 consisted of the review of our first two fiscal quarters and services related to filings with the SEC. We also retained GT and EY to perform certain other tax and consultative services. All fees paid to GT were reviewed, considered for independence and upon determination that such payments were compatible with maintaining such auditors' independence, approved by Sonic's audit committee prior to performance.

**Fiscal Years 2005 and 2004 Audit Firm Fee Summary**

During fiscal years 2005 and 2004, we retained EY and GT to provide services in the following categories and amounts:

| | Years Ended September 30, | |
|---|---|---|
| | 2005 | 2004 |
| **GT** | | |
| Audit Fees | $ 94,397 | $ 78,625 |
| Audit Related | 10,950 | 10,300 |
| Tax Fees | 20,637 | 620 |
| Other Fees | — | — |
| **EY** | | |
| Audit Fees | 6,115 | 49,810 |
| Audit Related | — | — |
| Tax Fees | — | 39,120 |
| Other Fees | 1,500 | 1,500 |

All of the services described above were approved by Sonic's audit committee and prior to performance. The Audit Committee may, in its discretion, delegate to one or more of its members the authority to pre-approve any audit or non-audit services to be performed by the independent auditors, provided that any such approvals are presented to the Audit Committee at its next scheduled meeting. The audit committee has determined that the payments made to its independent accountants for these services are compatible with maintaining such auditors' independence.

# REPORT OF THE AUDIT COMMITTEE [1]

The Audit Committee's role includes the oversight of our financial, accounting and reporting processes, our system of internal accounting and financial controls and our compliance with related legal and regulatory requirements, the appointment, engagement, termination and oversight of our independent auditors, including conducting a review of their independence, reviewing and approving the planned scope of our annual audit, overseeing the independent auditors' audit work, reviewing and pre-approving any audit and non-audit services that may be performed by them, reviewing with management and our independent auditors the adequacy of our internal financial controls, and reviewing our critical accounting policies and the application of accounting principles. The Audit Committee held six meetings during fiscal 2005.

Mssrs. Kleinman, Weis and Peercy meet the rules of the SEC for audit committee membership and are "independent" as that term is used in Item 7(d)(3)(iv) of Schedule 14A under the Exchange Act and under Nasdaq listing standards. In April 2004, the Board approved revisions to the Audit Committee Charter to reflect new rules and standards set forth in certain SEC regulations as well as changes to Nasdaq listing standards. A copy of the Audit Committee Charter was attached as Exhibit A to the 2004 proxy statement filed on April 26, 2004, and is available on Sonic's website.

As set forth in the Audit Committee Charter, management of Sonic is responsible for the preparation, presentation and integrity of Sonic's financial statements and for the effectiveness of internal control over financial reporting. Management and the accounting department are responsible for maintaining Sonic's accounting and financial reporting principles and internal controls and procedures designed to assure compliance with accounting standards and applicable laws and regulations. The independent auditors are responsible for auditing Sonic's financial statements and expressing an opinion as to their conformity with generally accepted accounting principles.

We have reviewed and discussed with our independent auditors, GT, matters required to be discussed pursuant to Statement on Auditing Standards No. 61 (Communications with Audit Committees). We have received from the auditors a formal written statement describing the relationships between the auditor and Sonic that might bear on the auditor's independence consistent with Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees). We have discussed with GT matters relating to its independence, including a review of both audit and non-audit fees, and considered the compatibility of non-audit services with the auditors' independence.

The members of the Audit Committee are not full-time employees of Sonic and are not performing the functions of auditors or accountants. As such, it is not the duty or responsibility of the Audit Committee or its members to conduct "field work" or other types of auditing or accounting reviews or procedures or to set auditor independence standards. Members of the Committee necessarily rely on the information provided to them by management and the independent accountants. Accordingly, the Audit Committee's considerations and discussions referred to above do not assure that the audit of Sonic's financial statements has been carried out in accordance with generally accepted auditing standards, that the financial statements are presented in accordance with generally accepted accounting principles or that Sonic's auditors are in fact "independent".

We have reviewed and discussed with management and GT the audited financial statements. We discussed with GT the overall scope and plans of their audit. We met with GT, with and without management present, to discuss results of their examination, their evaluation of Sonic's internal controls, and the overall quality of Sonic's financial reporting.

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[1] The material in this report is not "soliciting material", is not deemed filed with the SEC, and is not to be incorporated by reference in any of our filings under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in such filing.

Based on the reviews and discussions referred to above and our review of Sonic's audited financial statements for fiscal 2005, we recommended to the Board that the audited financial statements be included in the Annual Report on Form 10-K for the fiscal year ended September 30, 2005, for filing with the SEC.

Respectfully submitted,

AUDIT COMMITTEE

David C. Kleinman, Chair
Gary R. Weis
Paul S. Peercy

## EXECUTIVE OFFICERS OF SONIC

Our executive officers, who are appointed by the Board of Directors, hold office for one-year terms or until their respective successors have been duly elected and have qualified.

**Rimas P. Buinevicius** is our Chairman of the Board of Directors and Chief Executive Officer. (See " Directors Continuing in Office ".)

**Monty R. Schmidt** is our Chief Technology Officer and a Director. (See " Directors Continuing in Office ".)

**Kenneth A. Minor**, age 43, has been our Chief Financial Officer since June 1997, Assistant Secretary from December 1997 to February 2001 and Secretary since February 2001. From September 1993 to April 1997, Mr. Minor was employed as Vice President and Treasurer for Fruehauf Trailer Corporation, a manufacturer and global distributor of truck trailers and related after market parts and service where he was responsible for financial, treasury and investor relations functions. Prior to 1993, Mr. Minor served in various senior accounting and financial positions for public and private corporations as well as the international accounting firm of Deloitte Haskins and Sells. Mr. Minor is a certified public accountant and has a B.B.A. degree in accounting from Western Michigan University.

**Darrin T. Coulson**, age 40, has been our Senior Vice President of Worldwide Field Operations since August 2005 and served as Regional Sales Manager from November 2004 to August 2005. From May 2003 to November 2004, Mr. Coulson was President of BxVideo, a rich media services company he founded. From March 1994 to November 2001, Mr. Coulson served in various capacities for FORE Systems and its successor corporation, Marconi PLC, including Executive Vice President and General Manager of Global Services and President of the Americas Enterprise Business division, a $700 million enterprise.

## SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table shows information known to us about the beneficial ownership of our Common Stock as of January 17, 2006, by each stockholder known by us to own beneficially more than 5% of our Common Stock, each of our executive officers named in the Summary Compensation Table ("Named Executive Officers"), each of our directors, and all of our directors and executive officers as a group. Unless otherwise noted, the mailing address for these stockholders is 222 West Washington Avenue, Madison, Wisconsin 53703.

Beneficial ownership is determined in accordance with the rules of the SEC, and includes voting or investment power with respect to shares. Shares of common stock issuable upon the exercise of stock options or warrants exercisable within 60 days after January 17, 2006, which we refer to as Presently Exercisable Options, are deemed outstanding for computing the percentage ownership of the person holding the options but are not deemed outstanding for computing the percentage ownership of any other person. Unless otherwise indicated below, to our knowledge, all persons named in the table have sole voting and investment power with respect to their shares of common stock, except to the extent authority is shared by spouses under applicable law. The inclusion of any shares in this table does not constitute an admission of beneficial ownership for the person named below.

Based on currently available Schedules 13D and 13G filed with the SEC, we do not know of any beneficial owners of more than 5% of our Common Stock, other than listed below.

| Name of Beneficial Owner(1) | Number of Shares of Class Beneficially Owned | Percent of Class(2) |
|---|---|---|
| **Common Stock** | | |
| Monty R. Schmidt (3) | 3,309,604 | 10.4% |
| CCM Master Fund(4)<br>One North Wacker Drive – Suite 4725<br>Chicago, IL 60606 | 2,972,925 | 9.4 |
| 033 Asset Management LLC(5)<br>125 High Street, Suite 1405<br>Boston, MA 02110 | 2,425,728 | 7.7 |
| Rimas P. Buinevicius(6) | 2,371,180 | 7.2 |
| Arnold B. Pollard(7)<br>733 Third Avenue<br>New York, NY 10017 | 482,745 | 1.5 |
| Frederick H. Kopko, Jr.(8)<br>20 North Wacker Drive<br>Chicago, IL 60606 | 363,192 | 1.1 |
| Kenneth A. Minor(9) | 329,670 | 1.0 |
| Darrin T. Coulson(10) | 255,755 | * |
| David C. Kleinman(11)<br>1101 East 58th Street<br>Chicago, IL 60637 | 185,000 | * |
| Gary R. Weis(12)<br>P.O. Box 272<br>Deerfield, IL 60015 | 50,000 | * |
| Paul S. Peercy(12)<br>1415 Engineering Dr<br>Madison, WI 53706 | 40,400 | * |
| All Executive Officers and Directors as a Group (9 persons)(13) | 7,387,546 | 21.6% |

* less than 1%

(1) Sonic believes that the persons named in the table above, based upon information furnished by such persons, have sole voting and investment power with respect to the number of shares indicated as beneficially owned by them.

(2) Applicable percentages are based on 31,616,577 shares outstanding, adjusted as required by rules promulgated by the Securities and Exchange Commission.

(3) Includes 166,468 shares subject to Presently Exercisable Options.

(4) Information is based on Schedule 13G/A filed on February 9, 2005 by Clint D. Coghill, Coghill Capital Management, L.L.C., and CCM Master Qualified Fund, Ltd. Represents shares beneficially owned by CCM Master Fund, Ltd.; Coghill Capital Management, L.L.C. and Clint D. Coghill. Mr. Coghill is the managing member of Coghill Capital Management, L.L.C.; an entity which serves as the investment manager of CCM Master Fund, Ltd.

(5) Information is based on Schedule 13G filed on February 7, 2005 by 033 Asset Management, LLC. 033 Asset Management, LLC. is the investment manager of 033 Growth Partners I, L.P., 033 Growth Partners II, L.P., Oyster Pond Partners, L.P. and 033 Growth International Fund, Ltd.. Lawrence C. Longo is the Chief Operating Officer of 033 Asset Management LLC.
(6) Includes 1,166,666 shares subject to Presently Exercisable Options.
(7) Includes 482,745 shares subject to Presently Exercisable Options.
(8) Includes 180,000 shares subject to Presently Exercisable Options.
(9) Includes 315,273 shares subject to Presently Exercisable Options.
(10) Includes 49,570 shares subject to Presently Exercisable Options.
(11) Includes 185,000 shares subject to Presently Exercisable Options.
(12) Includes 40,000 shares subject to Presently Exercisable Options.
(13) Includes an aggregate of 2,625,722 Presently Exercisable Options.

The following table sets forth all the cash compensation paid by Sonic during the three fiscal years ended September 30, 2005 to our chief executive officer and our other executive officers who were serving as executive officers as of September 30, 2005.

| | | Annual Compensation | | | Long Term Compensation | |
|---|---|---|---|---|---|---|
| | | | | | Awards | |
| Name and Principal Position | Fiscal Year | Salary | Bonus | Other Annual Compen-sation(1) | Securities Underlying Options(#) | All Other Compensation |
| Rimas P. Buinevicius | 2005 | $248,077 | $ 40,000 | $ — | 50,000 | $ — |
| Chief Executive Officer | 2004 | 192,308 | — | 1,541 | — | — |
| and Chairman | 2003 | 136,538 | 250,000 | 4,181 | — | — |
| | | | | | | |
| Monty R. Schmidt | 2005 | 199,039 | 40,000 | — | 50,000 | |
| Chief Technology | 2004 | 168,269 | — | 2,404 | — | — |
| Officer and Director | 2003 | 144,615 | 250,000 | 5,790 | — | 19,424(2) |
| | | | | | | |
| Kenneth A. Minor | 2005 | 173,077 | 40,000 | 4,821 | 50,000 | |
| Chief Financial Officer | 2004 | 144,230 | — | 4,825 | — | — |
| and Secretary | 2003 | 128,462 | 100,000 | 4,484 | 100,000 | 5,826(2) |
| | | | | | | |
| Darrin T. Coulson(3) | 2005 | 139,615 | — | — | 225,000 | — |
| Senior Vice President – | 2004 | — | — | — | — | — |
| Field Operations | 2003 | — | — | — | — | — |

(1) Consists of personal use of company vehicle included as portion of executive's taxable compensation.
(2) Consists of compensation earned and deferred pursuant to Sonic's deferred compensation plan, along with accrued interest.
(3) Mr. Coulson became an executive officer in August 2005.

Employment Agreements

We entered into employment agreements with Rimas P. Buinevicius and Monty R. Schmidt and renewed them on substantially the same terms as the prior agreements in January 2001. The salaries of each of Messrs. Buinevicius and Schmidt are subject to increase each year at the discretion of the Board of Directors. Messrs. Buinevicius and Schmidt are also entitled to incidental benefits of employment under the agreements. Each of the employment agreements provides that if (i) Sonic Foundry breaches its duty under such employment agreement, (ii) the employee's status or responsibilities with Sonic Foundry has been reduced, (iii) Sonic Foundry fails to perform its obligations under such employment agreement, or (iv) after a Change in Control of Sonic Foundry, Sonic Foundry's financial prospects have significantly declined, the employee may terminate his employment and receive all salary and bonus owed to him at that time, prorated, plus three times the highest annual salary and bonus paid to him in any of the three years immediately preceding the termination. If the employee becomes disabled, he may terminate his employment and receive all salary owed to him at that time, prorated, plus a lump sum equal to the highest annual salary and bonus paid to him in any of the three years immediately preceding the termination. Pursuant to the employment agreements, each of Messrs. Buinevicius and Schmidt has agreed not to disclose our confidential information and not to compete against us during the term of his employment agreement and for a period of two years thereafter. Such non-compete clauses may not be enforceable, or may only be partially enforceable, in state courts of relevant jurisdictions.

A "Change in Control" is defined in the employment agreements to mean: (i) a change in control of a nature that would have to be reported in our proxy statement, ; (ii) Sonic Foundry is merged or consolidated or reorganized into or with another corporation or other legal person and as a result of such merger, consolidation or reorganization less than 75% of the outstanding voting securities or other capital interests of the surviving, resulting or acquiring corporation or other legal person are owned in the aggregate by our stockholders immediately prior to such merger, consolidation or reorganization; (iii) Sonic Foundry sells all or substantially all of its business and/or assets to any other corporation or other legal person, less than 75% of the outstanding voting securities or other capital interests of which are owned in the aggregate by our stockholders, directly or indirectly, immediately prior to or after such sale; (iv) any person (as the term "person" is used in Section 13(d) (3) or Section 14(d) (2) of the Securities Exchange Act of 1934 (the "Exchange Act") had become the beneficial owner (as the term "beneficial owner" is defined under Rule 13d-3 or any successor rule or regulation promulgated under the Exchange Act) of 25% or more of the issued and outstanding shares of our voting securities; or (v) during any period of two consecutive years, individuals who at the beginning of any such period constitute our directors cease for any reason to constitute at least a majority thereof unless the election, or the nomination or election by our stockholders, of each new director was approved by a vote of at least two- thirds of such directors then still in office who were directors at the beginning of any such period.

OPTIONS GRANTED IN FISCAL 2005

Sonic grants options to its executive officers under our employee stock option plans. As of September 30, 2005, options to purchase a total of 3,987,764 shares were outstanding under the plans, and options to purchase 3,472,123 shares remained available for grant thereunder. During Fiscal 2005, 375,000 shares were granted and no options to purchase shares were exercised by Named Executive Officers.

The following tables show for the fiscal year ended September 30, 2005 certain information regarding options granted to and held at year-end by the Named Executive Officers. Potential

| | Individual Grants | | | | Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term | |
|---|---|---|---|---|---|---|
| | Number of securities Underlying Options/SARs Granted (#) | % of Total Options/SARs Granted to Employees in Fiscal Year | Exercise or Base Price ($/Sh) | Expiration Date | 5%($) | 10%($) |
| Rimas P. Buinevicius | 50,000 | 5.6% | $ 1.45 | 11/26/2014 | $ 45,595 | $ 115,546 |
| Monty R. Schmidt | 50,000 | 5.6 | 1.45 | 11/26/2014 | 45,595 | 115,546 |
| Kenneth A. Minor | 50,000 | 5.6 | 1.45 | 11/26/2014 | 45,595 | 115,546 |
| Darrin T. Coulson | 200,000 | 22.4 | 1.35 | 7/5/2015 | 169,802 | 430,310 |
| | 25,000 | 2.8 | 1.62 | 11/1/2014 | 25,470 | 64,547 |

2005 FISCAL YEAR-END OPTION VALUES

| | Number of Unexercised Options/SARs at Fiscal Year-End(#) | | Value of Unexercised In-the-Money Options/SARs at Fiscal Year-End($) | |
|---|---|---|---|---|
| | Exercisable | Unexercisable | Exercisable | Unexercisable |
| Rimas P. Buinevicius | 1,150,000 | 50,000 | $ 213,760 | $ — |
| Monty R. Schmidt | 149,802 | 50,000 | 25,381 | — |
| Kenneth A. Minor | 298,607 | 83,334 | 92,083 | 29,667 |
| Darrin T. Coulson | — | 225,000 | — | — |

## REPORT OF THE EXECUTIVE COMPENSATION COMMITTEE [1]

The Executive Compensation Committee (the "Committee") of the Board of Directors is composed entirely of outside, non-management directors. The Committee sets and administers the policies governing annual compensation of executive officers, including cash compensation and stock option programs for executive employees.

### Compensation Policies

Sonic Foundry operates in the competitive and rapidly changing high technology and rich media communications environment. The goals of our executive compensation program are to motivate executives to achieve our business objectives in this environment and reward them for their achievement, foster teamwork, and attract and retain executive officers who contribute to our long-term success. During fiscal 2005, we used primarily salary, incentive bonuses, stock options and personal use of company vehicles to meet these goals. Sonic's executive compensation programs are intended to attract and retain qualified executives and to motivate them to achieve goals that will lead to appreciation of stockholder value.

Our philosophy and guiding principles are to provide compensation levels that are comparable to those offered by other leading high technology companies. Our compensation policies align the interests of our officers with the long-term interests of our stockholders through stock compensation. Another principle is that a substantial portion of each executive's compensation be in the form of an incentive bonus. Receipt of this bonus, is contingent upon meeting both individual performance goals and company objectives. However, we retain the authority to alter the bonus amounts because qualitative factors and long-term results need to be evaluated as well as the short-term operating results. Factors used in determining bonus amounts granted in November 2005 included individual performance impacting successful new product releases and achievement of 100+% Mediasite revenue growth. Executive bonus' granted in November 2005 totaled $150,000.

### Annual Compensation

The salary portion of executive compensation is determined annually by reference to multiple surveys of high technology companies. The executive officers are matched to each position by comparing their responsibilities to the survey description most accurately representing their position with us by content, organizational level and level of revenue. Given the officers' levels of responsibility and our past performance, we target a competitive salary for each executive officer. A substantial portion of the annual compensation of each executive officer would normally have been in the form of an incentive bonus, which becomes a greater portion of an officer's potential total compensation as the executive's level of responsibility increases.

[1] The material in this report is not "soliciting material," is not deemed filed with the SEC and is not to be incorporated by reference in any filing of Sonic under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

**Long-term Compensation.**

The Committee has utilized stock options for all employees to motivate and retain them for the long-term. The Committee believes that these forms of compensation closely align the employee's interests with those of stockholders and provide a major incentive to them in building stockholder value.

Options are typically granted annually following completion of the fiscal year and are subject to vesting provisions to encourage employees to remain employed with Sonic Foundry. The Committee did not grant any options to executives following completion of fiscal 2005.

Each executive officer receives stock options based upon that officer's relative position, responsibilities and performance by the individual over the previous fiscal year and the officer's anticipated performance, responsibilities and cash compensation. Additionally, we consider the net present value of the grant compared to typical grants at high technology companies of a similar size to Sonic Foundry. We also review the prior level of grants to the officers and to other members of senior management, including the number of shares that continue to be subject to vesting under outstanding options, in setting the level of options to be granted to the executive officers.

Stock options are granted at an option price equal to the fair market value of Sonic's common stock on the date of the grant and are subject to vesting over varying periods. The option-vesting period is designed to encourage employees to work with a long-term view of Sonic's welfare and to establish their long-term affiliation with Sonic. It is also designed to reduce employee turnover and to retain the knowledge and skills of valued staff.

**Chief Executive Officer Compensation**

In an effort to conserve cash in a weak economy, Mr. Buinevicius asked the compensation committee to reduce his base compensation from $250,000 to $200,000 as of January 1, 2001 and further to $1,229 in December 2001. Mr. Buinevicius was granted 750,000 Common Stock options issued under the Non-Qualified Stock Option Plan as consideration for reducing his salary and 250,000 performance-based stock options. The Committee increased Mr. Buinevicius' annual base compensation to $200,000 upon the successful sale of the desktop software business in July 2003, returned it to $250,000 in October 2004 and increased it to what the Committee believes to be the median rate for comparable company CEO's of $300,000 in November 2005. Further, Mr. Buinevicius was awarded a cash bonus of $50,000 in November 2005.

Respectfully submitted,

EXECUTIVE COMPENSATION COMMITTEE

David C. Kleinman
Arnold B. Pollard
Paul S. Peercy

**Compensation Committee Interlocks and Insider Participation**

The members of the Executive Compensation Committee of Sonic's Board of Directors for Fiscal 2005 were those named in the Executive Compensation Committee Report. No member of the Committee was at any time during Fiscal 2005 or at any other time an officer or employee of Sonic Foundry, Inc.

No executive officer of Sonic Foundry, Inc. has served on the board of directors or compensation committee of any other entity that has or has had one or more executive officers serving as a member of the Board of Directors of Sonic Foundry, Inc.

**SONIC STOCK PRICE PERFORMANCE**

The stock price performance graph below shall not be deemed to be incorporated by reference by any general statement incorporating by reference this annual report on form 10-K into any filing under the Securities Act of 1933, or under the Securities Exchange Act of 1934, except to the extent that we specifically incorporate this information by reference, and shall not otherwise be deemed soliciting material or filed under such acts, irrespective of our general incorporation language in such filing.

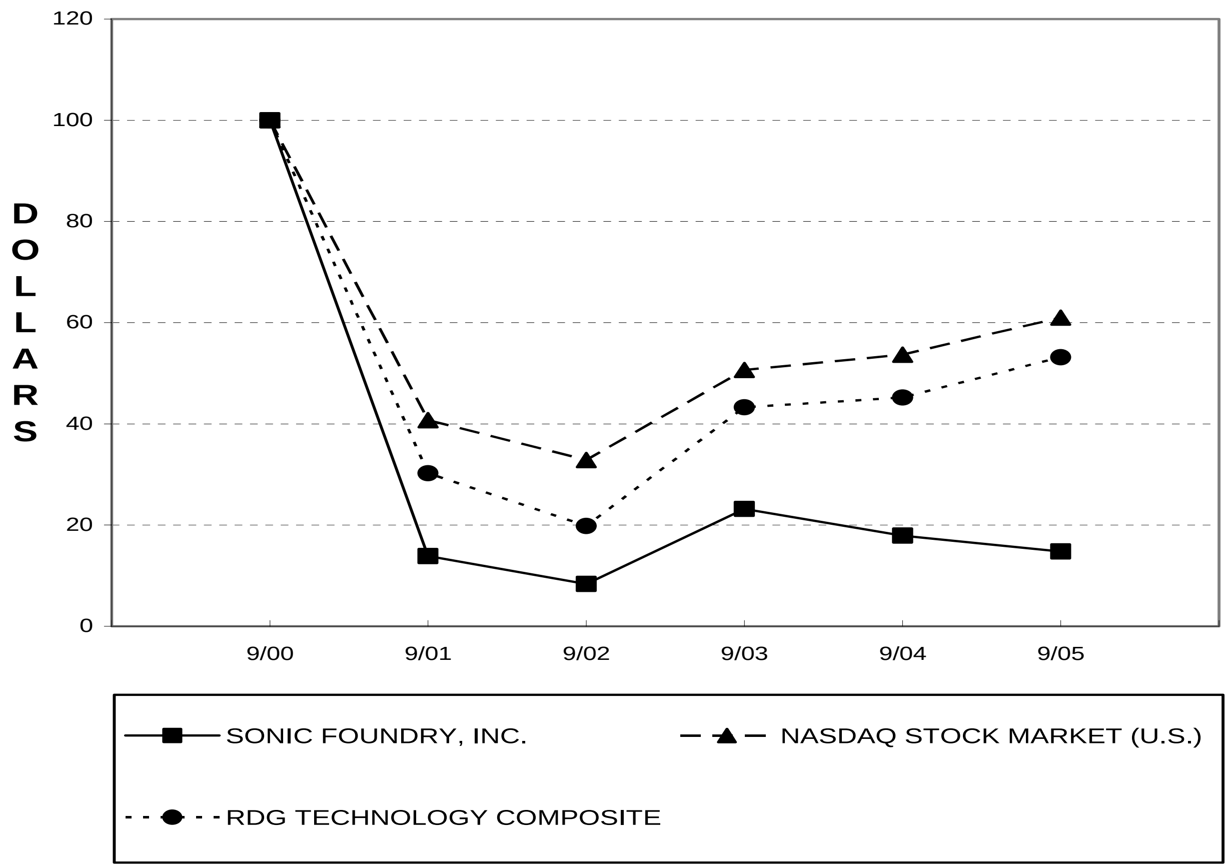
The graph below compares the cumulative total stockholder return on our Common Stock from September 30, 2000 through and including September 30, 2005 with the cumulative total return on The Nasdaq Stock Market (US only) and the RDG Technology Composite. The graph assumes that $100 was invested in our Common Stock on September 30, 2000 for each of the indexes and that all dividends were reinvested. Unless otherwise specified, all dates refer to the last day of each month presented. Our Common Stock is traded on the Nasdaq National Market and closed at $1.31 per share on September 30, 2005.

The comparisons in the graph below are based on historical data, with our Common Stock prices based on the closing price on the dates indicated, and are not intended to forecast the possible future performance of our Common Stock.

EDGAR REPRESENTATION OF DATA POINTS USED IN PRINTED GRAPHIC

| | Sonic Foundry | NASDAQ Stock Market (U.S.) | RDG Technology Composite |
|---|---|---|---|
| 9/30/00 | 100.00 | 100.00 | 100.00 |
| 9/30/01 | 13.86 | 40.72 | 30.25 |
| 9/30/02 | 8.34 | 32.86 | 19.82 |
| 9/30/03 | 23.19 | 50.65 | 43.26 |
| 9/30/04 | 17.92 | 53.68 | 45.21 |
| 9/30/05 | 14.76 | 60.97 | 53.16 |

## COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*
AMONG SONIC FOUNDRY, INC., THE NASDAQ STOCK MARKET (U.S.) INDEX
AND THE RDG TECHNOLOGY COMPOSITE INDEX




* $100 invested on 9/30/00 in stock or index-
including reinvestment of dividends.
Fiscal year ending September 30.

**CERTAIN TRANSACTIONS**

Frederick H. Kopko, Jr., a director and stockholder of Sonic Foundry, is a partner in McBreen & Kopko. Pursuant to the Directors' Stock Option Plan, Mr. Kopko has been granted options to purchase 160,000 shares of Common Stock at exercise prices ranging from $1.03 to $59.88. He also has options to purchase 40,000 shares of Common Stock at an exercise price of $1.09 pursuant to the 1999 Non – Qualified Stock Option Plan in his capacity as a director. During fiscal 2005, we paid the Chicago law firm of McBreen & Kopko certain compensation for legal services rendered subject to standard billing rates.

**Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934 requires Sonic's officers and directors, and persons who own more than ten percent of the Common Stock, to file reports of ownership and changes in ownership with the Securities and Exchange Commission. Based solely upon a review of Forms 3 and Forms 4 furnished to us pursuant to Rule 16a-3 under the Exchange Act during our most recent fiscal year, to Sonic Foundry's knowledge, all reporting persons complied with all applicable filing requirements of Section 16(a) of the Securities Exchange Act of 1934, as amended, with the following exceptions: Darrin T. Coulson inadvertently failed to timely file his Form

3 upon appointment to an executive officer position, and Frederick H. Kopko, Jr., Arnold B. Pollard, David C. Kleinman, Paul S. Peercy and Gary R. Weis each inadvertently failed to timely file their respective Form 4's upon receiving automatic grants of options in May 2005 pursuant to the Non-Employee Directors Stock Option Plan. As of the date of this Proxy Statement, the foregoing reporting persons have regained compliance with Section 16(a) reporting requirements.

**Code of Ethics**

Sonic has adopted a Code of Ethics (as defined in Item 406 of Regulation S-K) that applies to its principal executive, financial and accounting officers. Sonic Foundry will provide a copy of its code of ethics, without charge, to any investor that requests it. Requests should be addressed in writing to Mr. Kenneth Minor, Corporate Secretary, 222 West Washington Ave, Suite 775, Madison, WI 53703.

## COMMUNICATIONS WITH THE BOARD OF DIRECTORS

Any stockholder who desires to contact our Board or specific members of our Board may do so electronically by sending an email to the following address: *directors@sonicfoundry.com*. Alternatively, a stockholder can contact our Board or specific members of our Board by writing to: Stockholder Communications, Sonic Foundry Incorporated, 222 West Washington Avenue, Suite 775, Madison, WI 53703.

## STOCKHOLDER PROPOSALS

In order for a stockholder proposal to be considered for inclusion in our proxy statement and form of proxy relating to the Annual Meeting of Stockholders for fiscal year 2007, the proposal must be received by us no later than October 11, 2006 unless we change next year's annual meeting date by more than 30 days from March 15, 2007, in which event the deadline would be a reasonable time before we begin to print and mail our proxy materials. Additionally, Sonic will be authorized to exercise discretionary voting authority with respect to any stockholder proposal not disclosed in Sonic's 2007 proxy statement if Sonic has not received written notice of such proposal by December 25, 2006, unless we change next year's annual meeting date by more than 30 days from March 15, 2007, in which event we must receive the proposal within a reasonable time before we mail our proxy materials.

## OTHER MATTERS

The Board of Directors has at this time no knowledge of any matters to be brought before this year's Annual Meeting other than those referred to above. However, if any other matters properly come before this year's Annual Meeting, it is the intention of the persons named in the proxy to vote such proxy in accordance with their judgment on such matters.

## GENERAL

A copy of our Annual Report to Stockholders for the fiscal year ended September 30, 2005 is being mailed, together with this Proxy Statement, to each stockholder. Additional copies of such Annual Report and of the Notice of Annual Meeting, this Proxy Statement and the accompanying proxy may be obtained from us. We will, upon request, reimburse brokers, banks and other nominees, for costs incurred by them in forwarding proxy material and the Annual Report to beneficial owners of Common Stock. In addition, directors, officers and regular employees of Sonic and its subsidiaries, at no additional compensation, may solicit proxies by telephone, telegram or in person. All expenses in connection with soliciting management proxies for this year's Annual Meeting, including the cost of preparing, assembling and mailing the Notice of Annual Meeting, this Proxy Statement and the accompanying proxy are to be paid by Sonic.

**Sonic will provide without charge (except for exhibits) to any record or beneficial owner of its securities, on written request, a copy of Sonic's Annual Report on Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended September 30, 2005, including the financial statements and schedules thereto. Exhibits to said report will be provided upon payment of fees limited to Sonic's reasonable expenses in furnishing such exhibits. Written requests should be directed to Investor Relations, 222 West Washington Avenue, Suite 775, Madison, Wisconsin 53703.**

In order to assure the presence of the necessary quorum at this year's Annual Meeting, and to save Sonic the expense of further mailings, please date, sign and mail the enclosed proxy promptly in the envelope provided. No postage is required if mailed within the United States. The signing of a proxy will not prevent a stockholder of record from voting in person at the meeting.

By Order of the Board of Directors,

Kenneth A. Minor

Kenneth A. Minor
Secretary

January 23, 2006

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

# FORM 10-K

(Mark One)

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

For the fiscal period ended September 30, 2005

**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**<br>**(State or other jurisdiction of incorporation or organization)** | **39-1783372**<br>**(I.R.S. Employer Identification No.)** |
| **222 W. Washington Ave, Suite 775, Madison, WI 53703**<br>**(Address of principal executive offices)** | **(608) 443-1600**<br>**(Issuer's telephone number)** |
| **Securities registered pursuant to Section 12(b) of the Act:** | **None** |
| **Securities registered pursuant to Section 12(g) of the Act:** | **Common stock par value $0.01 per share** |

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act.

Yes No ✓

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.

Yes No ✓

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Yes ✓ No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No ✓

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No ✓

The aggregate market value of the voting and non-voting stock held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the Registrant's most recently completed second fiscal quarter was approximately $37,914,039.

The number of shares outstanding of the issuer's common equity was 30,849,159 as of December 5, 2005.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the 2006 Annual Meeting of Stockholders are incorporated by reference into Part III. A definitive Proxy Statement pursuant to Regulation 14A will be filed with the Commission no later than January 28, 2006.

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## PART I



## PART II



## PART III

**Sonic Foundry, Inc.**
**Annual Report on Form 10-K**
**For the Year Ended September 30, 2005**

***When used in this Report, the words "anticipate", "expects", "plans", "believes", "seeks", "estimates" and similar expressions are intended to identify forward-looking statements. These are statements that relate to future periods and include, but are not limited to, statements about the features, benefits and performance of our Rich Media products, our ability to introduce new product offerings and increase revenue from existing products, expected expenses including those related to sales and marketing, research and development and general and administrative, our beliefs regarding the health and growth of the market for Rich Media products, anticipated increase in our customer base, expansion of our products functionalities, expected revenue levels and sources of revenue, expected impact, if any, of legal proceedings, the adequacy of liquidity and capital resources, and expected growth in business. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, market acceptance for our products, our ability to attract and retain customers and distribution partners for existing and new products, our ability to control our expenses, our ability to recruit and retain employees, the ability of distribution partners to successfully sell our products, legislation and government regulation, shifts in technology, global and local business conditions, our ability to effectively maintain and update our products and service portfolio, the strength of competitive offerings, the prices being charged by those competitors, and the risks discussed elsewhere herein. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.***

# PART I

## ITEM 1. BUSINESS

Sonic Foundry, Inc. is in the business of developing complete, economical, timesaving and easy-to-use solutions for one-to-many communications (our "Rich Media" business). The Rich Media business was formed in October 2001, when our wholly-owned subsidiary, Sonic Foundry Systems Group, Inc. acquired the assets and assumed certain liabilities of Mediasite, Inc. Our internally developed software code, coupled with our acquired systems technology, includes advanced publishing tools and media access technologies operating across multiple digital delivery platforms to significantly enhance a host of enterprise-based media applications. Our solutions are based on unique technologies that enhance media communications through the extensive use of rich media, defined as a media element that combines graphics, text, video, audio and metadata in a single data file. Our technology evolved from a four-year Carnegie Mellon University research effort funded by major government (DARPA, NSF, NASA) and private organizations (CNN, Intel, Boeing, Microsoft, Motorola, Bell Atlantic). Our core product is the family of Mediasite presentation recorders ("Mediasite"), complete presentation recording systems for live or on-demand viewing over the Internet, intranet or recording to physical media. Related products and services include server software applications and customer support, installation, training and content hosting services.

Sonic Foundry, Inc., the parent company of our Rich Media business, was founded in 1991, incorporated in Wisconsin in March 1994 and merged into a Maryland corporation of the same name in October 1996. Our executive offices are located at 222 West Washington Ave., Madison, Wisconsin, 53703 and our telephone number is (608) 443-1600. Our corporate website is http://www.sonicfoundry.com. We make available, free of charge, at the "Investor Information" section of our website, our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to reports to be filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after the filing of such reports with the Securities and Exchange Commission.

### Business and Industry Background

Most organizations have a need to communicate, not just internally but externally. In the case of universities and colleges, capturing online lectures and materials is becoming a requirement. Likewise, outbound communications from corporate entities is essential to reach key partners and customers. There are ready examples of this need when investigating the workflow of product managers, customer service groups and product trainers.

Yet, significant communication delivery barriers remain. The key problem has been producing communication content economically and delivering it quickly to the person who requires it.

Many organizations also have a need to capture multimedia information as an alternative or supplement to written notes or other documentation such as the capture of content presented in meetings, records of court proceedings or the results of electronic test equipment used in certifying new products.

Reinforcing this need are the economics behind communication and content capture. More institutions are realizing a profit potential or significant cost savings by utilizing new rich media communications systems. In the case of secondary education, more institutions are establishing distance learning programs which offer a higher margin return on tuition. In the case of corporations, they are discovering true savings in rich media communications via their day-to-day functional duties such as channel communications, sales training, product support and customer and dealer training.

We offer an easy to use system for recording and publishing multimedia presentations and distributing them either in real-time over the Internet or an intranet, archiving them for on-demand use or saving them to portable physical media such as CD, DVD or Flash. This offering provides significant advantages related to creating and viewing the content. Our unique approach is best understood through an appreciation of the way we've moved the content through the publishing workflow process. With a simple press of the record and stop button by the presenter, no authoring, no post production and no required proprietary software other than standard Windows media and Internet Explorer is required.

We believe this offering is powerful because it attempts to solve a very complex workflow integration problem. Specifically, all of the technologies involved in our offering, such as streaming, database integration, video and graphic capture and Internet viewing are not easily combined, much less understood. For this and other reasons, we believe Mediasite delivers an elegant, easy to implement solution that shows the promise of breaking through traditional barriers of content production and providing a new form of automated communication.

The technology underlying the product is intended to eliminate an overly complicated problem that has restricted market growth and expansion. We believe the breadth of potential users can grow quite broadly. By way of example, videoconferencing has been a technology with great promise but limited demonstrated use. We believe this market has stalled due to the complexity of actually invoking a videoconference, the need to have IT staff involved and the uncertainty of quality remote connections. Even with these handicaps, the video conferencing market has become a billion dollar industry having penetrated less than 10% of the estimated 25 million conference rooms that currently exist worldwide. Our own system offering is targeted at the same conference room and lecture hall setting and is primarily why we chose the audio / video ("A/V") reseller channel as our primary distribution partner. Because many of the technology hurdles and use issues have been solved through an Internet approach, we believe the web presentation and webcasting markets will expand far beyond the established video conferencing market.

In many ways, the Mediasite appliance has the characteristic of an Internet projector. Just as projectors first extended overhead slides and PowerPoint presentations to the screen, Mediasite takes the same presentation outside the confines of a room to the rest of the world while also creating an archive. Projectors entered the market at a price of approximately $20 thousand and sold into large lecture rooms. Over time, the economies of manufacturing and distribution placed the device in many smaller rooms. Today, the LCD projector has become truly mobile and is often carried under the arm by presenters.

Some of our customers view Mediasite as a media event recorder. Our device is being used to capture critical communications and acts as an archiving tool. In some instances, Mediasite is being used as a knowledge capture device capable of archiving presentations. In general, we are finding that our customers predominantly use Mediasite in this asynchronous mode (not live). They value the flexibility of capturing content and having it available for later retrieval. So while the live capability offers some feature appeal, the real utilization is tending towards on-demand, off line access.

Mediasite addresses a broad variety of communications for business, government, and education ranging from executive briefings, product marketing, and sales presentations to public safety/emergency management and community outreach, to online lectures and distance learning.

### Rich Media Products and Services

Mediasite is a unique solution that easily, inexpensively and automatically webcasts and records information-rich presentations. The presenter and the information presented are automatically synchronized in split screen format, which is available instantly for live or on-demand delayed access. The result is an easily distributed, high quality, TiVo-like viewing experience, never before available at the touch of a button for so minimal a cost.

This communications breakthrough makes creating interactive presentations inexpensive and easy, with no pre- or post-production technical labor required. Applications include capturing and presenting executive briefings, corporate training, product management, R & D collaboration and distance learning.

The Mediasite solution family is comprised of:

- Mediasite Rich Media Recorders
- Mediasite Rich Media Servers
- Mediasite Rich Media Enabling Services
- SmartServe Services

**Mediasite Rich Media Recorders** are the leading content capture appliances to record presentation video, audio and supporting visuals with the touch of a single button. In summer 2005 we released the newest version of Mediasite Recorders, the 440 Series, which includes:

- Mediasite RL440—a room-based Recorder designed for presentation facilities such as conference rooms, training rooms and lecture halls
- Mediasite ML440—a portable Recorder designed to capture live remote events, conferences, tradeshows or ad-hoc presentations anywhere
- Mediasite VL440 (this year's new addition to the Mediasite Recorder family)—a room-based Recorder designed to capture and share videoconference-based presentations and meetings

Accompanying all Mediasite 440 Recorders this year is the new Mediasite Rich Media Editor, allowing customers to edit their presentations before publishing to the web.

**Mediasite Rich Media Server** expands any Mediasite Recorder into a versatile web communication and rich media management platform. With Mediasite LX Server, any presentations captured with a Mediasite Recorder can be immediately streamed live to the Web or published to customizable online catalogs for on-demand access anytime. Mediasite LX Server provides security, organization, cataloging customization and management of rich media content.

**Mediasite Rich Media Enabling Services** offer managed hosting, content management and delivery services coupled with our line of Rich Media Recorders. The hosting services enable organizations to quickly and easily take advantage of the Mediasite rich media communications platform, without having to wade through the complexities associated with their IT or network infrastructure issues. As a complete, turnkey offering, these services will help organizations of all sizes get their rich media communications initiatives up and running quickly and effortlessly. It can serve as a hassle-free long-term solution, as well as a low-risk way to utilize rich media before bringing hosting requirements in-house.

**SmartServe Services** offer Mediasite customers technical support and product maintenance services through annual, renewable SmartServe Assurance contracts. The majority of our customers purchase SmartServe contracts when they purchase their Mediasite product. SmartServe contracts are priced at approximately 18% of the Mediasite list price. SmartServe contracts entitle customers to: software upgrades for Mediasite Recorders and Servers; unlimited technical support assistance via phone, email or the web; extension of their Recorder hardware warranty from the standard 90 days to one year; advance Recorder hardware replacement; and authorized access to the SmartServe Portal providing product hot fixes, downloads, knowledge base articles, tutorials, documentation and other technical resources. We also offer additional fee-based SmartServe technical services including installation, training and consulting.

### Other Products and Activities

Publisher is a product for creating accessible and searchable rich media presentations by using meta-tagging tools to identify and extract audio, video, and other textual cues. Publisher then allows the user to quickly and accurately locate media files by keyword or topic. Users can view scores and descriptive information to determine relevancy of their search results, and watch the returned clips with Publisher's Highlights Indexing Module.

The Publisher product is no longer maintained as a stand-alone product but significant portions of the technology underlying Publisher are based on patented technology defined as the integration of speech, language and image processing (ISLIP). This patented technology provides the capability of extracting and creating metadata from time-based media and includes constructing meaningful indices enabling effective and efficient search and retrieval of rich media. Another patented technology "video skimming" provides users the capability of reviewing rich media faster than real-time. We are actively researching and developing further commercialization of these technologies and expect to apply the resulting products or enhancements to existing products to broader market opportunities. One such effort is the nearly complete development contract with the United States Department of Justice for a project to examine how state and local law enforcement agencies can better process and manage audio and video media. We developed a set of media analysis software components that form the foundation for addressing multiple law enforcement applications related to media, such as the indexing and cataloging of media, data mining and electronic surveillance.

### Future Product Directions

Our engineering efforts continue to expand the scale and scope of Mediasite—particularly for the Mediasite Server and related software. Future development is targeted toward:

- Incorporating enterprise infrastructure support to ensure the scalability and performance of Mediasite implementations in larger and distributed organizations
- Integrating with other content applications
- Enriching content to be accessible and meaningful to viewers with visual or audio disabilities (e.g. captioning of rich media content)
- Providing alternative content viewing experiences for new computing devices
- Leveraging Sonic Foundry's advanced engineering development of media analysis software

We expect to further leverage our previous experience with media analysis (i.e. the Publisher product line for video search and retrieval) as well as the results of the Department of Justice-funded project for the development of advanced media analysis components, and media analysis-based solutions that complement Mediasite. These solutions will provide powerful content-based searching of archived rich media content, enhanced rich media content navigation and personalization and greater automation in the creation of rich media content that is accessible to users with disabilities. Powering these solutions will be our in-house technologies for speech, language and image understanding.

### Selling and Marketing

We sell and market our offerings through a sales force that manages a reseller channel of value-added resellers, system integrators, consultants and distributors. These third party representatives have a unique specialization and understanding of both audio/video systems and IT networking. For this reason, we have chosen to be highly selective and targeted by bringing on only the most qualified resellers that understand the nuances of media and IT network issues. In 2005, we utilized roughly 50 resellers who have demonstrated these qualifications and have sold our products to over 350 total end users, to date. The focus has been primarily in the United States and primarily to customers we've identified as having the greatest potential for high use: presenters, trainers, lecturers, marketers and leaders who have a routine need to communicate to many people in the higher education, government, health industry and certain corporate markets. Despite our primary attention on the North American market, reseller and customer interest outside of North America has resulted in extra-continental resellers of our Mediasite products, covering customers in Japan, Australia, New Zealand, the Middle East, Europe, Africa and South America. Total billings for Mediasite product and support outside North America totaled 17% in 2005 and 13% in 2004. Between Q4 2005 and Q1 2006 we added sales representatives in Canada, Belgium and New Zealand to cover opportunities in Canada, Europe and the South Pacific. Billings for Mediasite product and support services to our two largest customers were 11% each in 2005 and 2004, while no individual customer was over 10% in 2003.

Vertical market expansion - Currently, nearly half our revenues are realized from the education and distance learning markets. Government and corporate markets lag education users in adoption, but have grown in 2005 to approximately 24% and 20% of revenues as market awareness of web presentation and conferencing solutions expand. Similarly, we are seeing expanded interest from associations, legal, medical, defense, engineering and marketing organizations and may use targeted programs to focus on such groups specifically to build new markets as others become more established.

Repeat orders - Most customers will buy a single system, often a mobile unit, to test the full capability of the system. Larger enterprises and facilities have followed up with multiple unit orders following a test of the capabilities of the system. For this reason, we have specifically targeted larger entities that have more than 500 employees and multiple offices and that have found service provider solutions in conferencing more costly. In 2005, 44% of billings to end users were preexisting customers.

Renewals - As is typical in the industry, we offer service contract extensions, for a fee to our customer base.

Marketing efforts span the spectrum of reseller sales demonstrations, tradeshows, web page information, webinars, brochures, direct mail, print advertisement and white papers. We often request and receive press release quotes and written or multimedia testimonials from satisfied, high-profile reference customers, particularly those that demonstrate innovative and valuable uses of the Mediasite product. We solicit respected industry magazines and trade organizations to review our product and use independent agents as introductions to new channels or customers. We have a database of potential customers in the government, education and corporate marketplaces and have established a selected process of targeting specific verticals that have a direct and demonstrated need for our offerings.

### Operations

We currently contract with two third parties to build the hardware of our Mediasite product and typically purchase quantities for specific customer orders. Product is shipped to us, where we load our proprietary software, test the unit and ship it either direct to the customer or to a reseller. The hardware manufacturer provides a limited one-year warranty on the hardware, which we pass on to our customers who purchase our support plan. We believe there are numerous sources and alternatives to the existing production process. To date, we have not experienced any material difficulties or delays in the manufacture and assembly of our system products, or material returns due to product defects.

## OTHER INFORMATION

### Competition

The market for digital rich media is relatively new, and we face competition from other companies that provide digital media applications. Companies, like Webex, Microsoft (Office Live Meeting), and Raindance offer collaboration and web conferencing applications, while Microsoft, Macromedia and Accordent provide authoring capability. Other competitors such as Autonomy offer an enterprise approach to webcasting that attempt to sell a full rich media database and indexing system on top of the webcasting solution. The more successful we are in the emerging market for rich media, the more competitors are likely to emerge, including turnkey media application streaming media platform developers and digital media applications service providers (including for digital musical subscription). We may also face competition from foreign suppliers and LMS (learning management system) or education IT companies. We may also compete indirectly with larger system integrators who embed or integrate these directly competing technologies into their product offerings. It is possible that we may work with these same larger companies on one customer bid and compete with them on another. In the future, we may compete with other video services vendors as well as web conferencing vendors. In addition, we may compete with our current and potential customers who may develop software or perform application services internally.

We believe that the principal competitive factors in our market include:

- functionality, quality and performance;
- ease of use, reliability, scalability and security of services;
- customer service and support;
- establishing a significant base of customers and distribution partners;
- ability to introduce new products to the market in a timely manner;
- ability to integrate with third-party offerings and services; and
- pricing.

We believe we compete favorably with our competitors. However, the market for our products is relatively small today, and therefore even continued success against competitors does not guarantee that we can grow our business to profitable levels. Our ability to become a profitable and sustainable business is highly dependent on the growth of the Internet and the use of rich media for general communications.

### Intellectual Property

The status of United States patent protection in the Internet industry is not well defined and will evolve as the U.S. Patent and Trademark Office grants additional patents. We currently have 5 patent applications pending in the United States, of which none have been issued, and one patent application pending internationally. We may seek additional patents in the future. We do not know if our patent applications or any future patent application will result in any patents being issued with the scope of the claims we seek, if such patents are issued at all. We do not know whether any patents we may receive will be challenged, invalidated or be of any value. It is difficult to monitor unauthorized use of technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States, and our competitors may independently develop technology similar to ours. We will continue to seek patent and other intellectual property protections, when appropriate, for those aspects of our technology that we believe constitute innovations providing significant competitive advantages. The pending, and any future, patent applications may not result in the issuance of valid patents.

Our success depends in part upon our rights to proprietary technology. We rely on a combination of copyright, trade secret, trademark and contractual protection to establish and protect our proprietary rights. We have filed for nine U.S. and four foreign country trademarks, of which three U.S. and one foreign country trademarks are registered. We require our employees to enter into confidentiality and nondisclosure agreements upon commencement of employment. Before we will disclose any confidential aspects of our services, technology or business plans to customers, potential business distribution partners and other non-employees, we routinely require such persons to enter into confidentiality and nondisclosure agreements. In addition, we require all employees, and those consultants involved in the deployment of our services, to agree to assign to us any proprietary information, inventions or other intellectual property they generate, or come to possess, while employed by us. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our services or technology. These precautions may not prevent misappropriation or infringement of our intellectual property.

Third parties may infringe or misappropriate our copyrights, trademarks and similar proprietary rights. In addition, we may be subject to claims of alleged infringement of patents and other intellectual property rights of third parties. We may be unaware of filed patent applications which have not yet been made public and which relate to our services.

Intellectual property claims may be asserted against us in the future. Intellectual property litigation is expensive and time-consuming and could divert management's attention away from running our business.

Intellectual property litigation could also require us to develop non-infringing technology or enter into royalty or license agreements. These royalty or license agreements, if required, may not be available on acceptable terms, if at all. Our failure or inability to develop non-infringing technology or license the proprietary rights on a timely basis would harm our business.

**Research and Development**

We believe that our future success will depend in part on our ability to continue to develop new business, and to enhance our existing business. Accordingly, we invest a significant amount of our resources in research and development activities. During the fiscal years ended September 30, 2005 and 2004, we spent $1.8 million and $1.6 million on internal research and development activities for our Rich Media business. These amounts represent 22% and 36% of total revenues in each of those years. Internal research and development activities associated with our discontinued Media Services and Desktop Software operations are reflected in the discontinued operations line items of such businesses in the statement of operations.

In October 2001, we acquired the assets of Mediasite, Inc. which includes the underlying technology of our current Publisher and Mediasite products for a total of $9.1 million. Mediasite, Inc. derived its core technology from a Carnegie Mellon University ("CMU") research effort funded by leading government agencies and private corporations for which it obtained a license. Simultaneously with the acquisition, we entered into a license agreement with CMU for the core technology.

**Employees**

As of September 30, 2005, 2004 and 2003, we had 54, 47, and 32 full-time employees, respectively. All of these employees were employed in our Rich Media business. Our employees are not represented by a labor union, nor are they subject to a collective bargaining agreement. We have never experienced a work stoppage and believe that our employee relations are satisfactory.

## ITEM 1A. RISK FACTORS

The occurrences or any of the following risks could materially and adversely affect our business, financial condition and operating results.

WE MAY NEED TO RAISE ADDITIONAL CAPITAL IF WE DO NOT QUICKLY BECOME PROFITABLE.

Our cash used in operating activities was approximately $3.3 million for the year ended September 30, 2005 and $243 thousand for the quarter ended September 30, 2005. Based on our cash balance at September 30, 2005 of $4.3 million and our expectation that we'll reach cash flow breakeven in fiscal 2006, we anticipate having sufficient cash resources for at least the next twelve months. Despite our belief that we have sufficient cash to fund operations in 2006, we believed it was prudent to raise additional cash through the issuance of common stock. In November 2005, we issued 747 thousand shares and 149 thousand common stock purchase warrants to certain individual investors, and received proceeds of $725 thousand. If we do not become profitable in 2006 or our losses increase, we may need additional capital. The business environment may not be conducive to raising additional financing. If we require additional financing, the terms of such financing may heavily dilute the ownership interests of current investors and cause our stock price to fall significantly or we may not be able to secure financing upon acceptable terms at all.

WE MAY NOT EARN REVENUES SUFFICIENT TO REMAIN IN BUSINESS.

Our ability to become profitable depends on whether we can sell our Rich Media products for more than it costs to produce and support them. Our future sales also need to provide sufficient margin to support our ongoing operating activities. The success of our revenue model will depend upon many factors including:

- Our ability to develop and market our products;
- The extent to which consumers and businesses use our products; and
- Our ability to price our offerings in order to give us adequate margins.

Because of the early stage of our Rich Media business, and the evolving nature of our business, we cannot predict whether our revenue model will prove to be viable, whether demand for our products will materialize at the prices we expect to charge, or whether current or future pricing levels will be sustainable. Our stock price and business viability is dependent upon our ability to grow our revenues and manage our costs.

WE HAVE A HISTORY OF LOSSES.

For the year ended September 30, 2005, we had a gross margin of $5.6 million on revenues of $8.3 million with which to cover sales, marketing, research, development and general administrative costs. Our sales, marketing, research, development and general administration costs are large in comparison to our revenues, due partly to the expense of developing leads and relatively long sales cycles involved in selling products that are not yet considered "mainstream" technology investments. For the year ended September 30, 2005, these expenses were over 50% of our total revenues. Although we expect our operating losses as a percentage of revenues to continue to decline and reach breakeven in the near future, we may never achieve profitability.

OUR SUCCESS IS DEPENDENT UPON A SUFFICIENT NUMBER OF CUSTOMERS ACCEPTING OUR PRODUCTS.

We cannot predict how the market for our Rich Media products will develop, and part of our strategic challenge will be to convince enterprise customers of the productivity, improved communications, cost savings and other benefits of our Rich Media products. Our future revenues and revenue growth rates will depend in large part on our success in delivering these products effectively and creating market acceptance for these products. If we fail to do so, our products will not achieve widespread market acceptance, and we may not generate significant revenues to offset our development and sales and marketing costs, which will hurt our business. Additionally, our future success will continue to depend upon our ability to develop new products or product enhancements that address future needs of our target markets and to respond to these changing standards and practices.

MULTIPLE UNIT SALES MAY FAIL TO MATERIALIZE.

We need to sell multiple units to educational, corporate and government institutions in order to sell most efficiently and become profitable. In 2005, 44% of revenues were to preexisting customers and 89 customers had cumulatively purchased multiple units compared to 35% of revenues and 35 customers in 2004. While we have addressed a strategy to accomplish this, a customer may choose not to make expected purchases of our products. The failure of our customers to make expected purchases will harm our business.

IF OUR MARKETING AND LEAD GENERATION EFFORTS ARE NOT SUCCESSFUL, OUR BUSINESS WILL BE HARMED.

We believe that continued marketing efforts will be critical to achieve widespread acceptance of our Rich Media products. Our marketing campaign may not be successful given the expense required. For example, failure to adequately generate and develop sales leads could cause our future revenue growth to decrease. In addition, our inability to generate and cultivate sales leads into large organizations, where there is the potential for significant use of our products, could have a material effect on our business. We may not be able to identify and secure the number of strategic sales leads necessary to help generate marketplace acceptance of our products. If our marketing or lead-generation efforts are not successful, our business and operating results will be harmed.

THE LENGTH OF OUR SALES AND DEPLOYMENT CYCLE IS UNCERTAIN, WHICH MAY CAUSE OUR REVENUES AND OPERATING RESULTS TO VARY SIGNIFICANTLY FROM QUARTER TO QUARTER AND YEAR TO YEAR.

During our sales cycle, we spend considerable time and expense providing information to prospective customers about the use and benefits of our products without generating corresponding revenues. Our expense levels are relatively fixed in the short-term and based in part on our expectations of future revenues. Therefore, any delay in our sales cycle could cause significant variations in our operating results, particularly because a relatively small number of customer orders represent a large portion of our revenues.

We anticipate that some of our largest sources of revenues will be government entities and large corporations that often require long testing and approval processes before making a decision to purchase our products. In general, the process of selling our products to a potential customer may involve lengthy negotiations. As a result, we anticipate that our sales cycle will be unpredictable. Our sales cycle will also be subject to delays as a result of customer-specific factors over which we have little or no control, including budgetary constraints and internal approval procedures.

Our products are aimed toward a broadened business user base within our key markets. These products are relatively early in their product life cycles and we are relatively inexperienced with their sales cycle. We cannot predict how the market for our products will develop and part of our strategic challenge will be to convince targeted users of the productivity, improved communications, cost savings and other benefits. Accordingly, it is likely that delays in our sales cycles with these products will occur and this could cause significant variations in our operating results.

THERE IS A GREAT DEAL OF COMPETITION IN THE MARKET FOR OUR PRODUCTS, WHICH COULD LOWER THE DEMAND FOR OUR PRODUCTS.

The market for digital rich media is relatively new, and we face competition from other companies that provide digital media applications. Companies, like Webex, Placeware (Microsoft), and Raindance offer collaboration and web conferencing applications, while Microsoft, Macromedia and Accordent provide authoring capability and other competitors such as Autonomy offer an enterprise approach to webcasting that attempts to sell a full rich media database and indexing system on top of the webcasting solution. If one of these alternative approaches is received more favorably in the marketplace, a new approach or technology is developed or an existing or new competitor markets more effectively than we do or we otherwise do not compete effectively, our business will be harmed. In addition, the more successful we are in the emerging market for rich media, the more competitors are likely to emerge, including turnkey media application; streaming media platform developers; digital music infrastructure providers; and digital media applications service providers (including for digital musical subscription). Many of our competitors have far greater financial resources than we do, and could easily overtake the marketplace and severely harm our business. We may also face competition from foreign suppliers and competition from LMS or education IT companies.

The presence of these competitors could reduce the demand for our systems, and we may not have the financial resources to compete successfully.

OUR DISTRIBUTION CHANNELS ARE NEW AND UNPROVEN.

Audio/visual distributors have not fully committed to our products. Because our products are complicated, we may have difficulty in obtaining such commitments. In addition, Tandberg and Polycom, two prominent manufacturers, may displace us with a competitive offering, leaving us the need to find a new distribution source. If we cannot set up an efficient distribution channel, or if we are unable to manage our distributor relationships, our business could be harmed.

OUR CUSTOMERS MAY USE OUR PRODUCTS TO SHARE CONFIDENTIAL AND SENSITIVE INFORMATION, AND IF OUR SYSTEM SECURITY IS BREACHED, OUR REPUTATION COULD BE HARMED AND WE MAY LOSE CUSTOMERS.

Our customers may use our products to share confidential and sensitive information, the security of which is critical to their business. Third parties may attempt to breach our security or that of our customers. We may be liable to our customers for any breach in security, and any breach could harm our reputation and cause us to lose customers. In addition, customers are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays or loss of data. We may be required to expend significant capital and other resources to further protect against security breaches or to resolve problems caused by any breach, including litigation-related expenses if we are sued.

THE TECHNOLOGY UNDERLYING OUR PRODUCTS AND SERVICES IS COMPLEX AND MAY CONTAIN UNKNOWN DEFECTS THAT COULD HARM OUR REPUTATION, RESULT IN PRODUCT LIABILITY OR DECREASE MARKET ACCEPTANCE OF OUR PRODUCTS.

The technology underlying our products is complex and includes software that is internally developed, software licensed from third parties and hardware purchased from third parties. These products may contain errors or defects, particularly when first introduced or when new versions or enhancements are released. We may not discover defects that affect our current or new applications or enhancements until after they are sold. Any defects in our products and services could:

- Damage our reputation;
- Cause our customers to initiate product liability suits against us;
- Increase our product development resources;
- Cause us to lose sales; and
- Delay market acceptance of our products.

Our insurance coverage may not be sufficient to cover our complete liability exposure.

IF WE ARE VIEWED ONLY AS COMMODITY SUPPLIERS, OUR MARGINS AND VALUATIONS WILL SHRINK.

We need to provide value-added services in order to become less of a commodity supplier. This entails building long-term customer relationships. If we fail to do so, our margins will shrink, and our stock may become less valued to investors.

OUR SUCCESS DEPENDS UPON THE PROPRIETARY ASPECTS OF OUR TECHNOLOGY.

Our success and ability to compete depend to a significant degree upon the protection of our proprietary technology. We currently have five patent applications pending in the United States and one internationally, although none have been issued. We may seek additional patents in the future. Our current patent applications cover different aspects of the technology used in our patents and are important to our ability to compete. However, it is possible that:

- our pending patent applications may not result in the issuance of patents;
- any patents acquired by or issued to us may not be broad enough to protect us;
- any issued patent could be successfully challenged by one or more third parties, which could result in our loss of the right to prevent others from exploiting the inventions claimed in those patents;
- current and future competitors may independently develop similar technology, duplicate our services or design around any of our patents; and
- effective patent protection, including effective legal-enforcement mechanisms against those who violate our patent-related assets, may not be available in every country in which we do business.

WE ALSO RELY UPON TRADEMARKS, COPYRIGHTS AND TRADE SECRETS TO PROTECT OUR TECHNOLOGY, WHICH MAY NOT BE SUFFICIENT TO PROTECT OUR INTELLECTUAL PROPERTY.

We also rely on a combination of laws, such as copyright, trademark and trade secret laws, and contractual restrictions, such as confidentiality agreements and licenses, to establish and protect our technology. We have filed for nine U.S. and four foreign country trademarks, of which three U.S. and one foreign country trademarks are registered. These forms of intellectual property protection are critically important to our ability to establish and maintain our competitive position. However,

- third parties may infringe or misappropriate our copyrights, trademarks and similar proprietary rights;
- laws and contractual restrictions may not be sufficient to prevent misappropriation of our technology or to deter others from developing similar technologies;
- effective trademark, copyright and trade secret protection, including effective legal-enforcement mechanisms against those who violate our trademark, copyright or trade secret assets, may be unavailable or limited in foreign countries;
- other companies may claim common law trademark rights based upon state or foreign laws that precede the federal registration of our marks; and
- policing unauthorized use of our services and trademarks is difficult, expensive and time-consuming, and we may be unable to determine the extent of any unauthorized use.

Reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third parties to benefit from our technology without paying us for it, which would significantly harm our business.

IF OTHER PARTIES BRING INFRINGEMENT OR OTHER CLAIMS AGAINST US, WE MAY INCUR SIGNIFICANT COSTS OR LOSE CUSTOMERS.

Other companies may obtain patents or other proprietary rights that would limit our ability to conduct our business and could assert that our technologies infringe their proprietary rights. We could incur substantial costs to defend any litigation, even if without merit, and intellectual property litigation could force us to cease using key technology, obtain a license, or redesign our products. In the course of our business, we may sell certain systems to our customers, and in connection with such sale, we may agree to indemnify these customers from claims made against them by third parties for patent infringement related to these systems. In particular, claims are currently being made by holders of patents against learning institutions using streaming in their curriculum. We could be subject to similar claims, which could harm our business.

IF WE LOSE THE SERVICES OF RIMAS P. BUINEVICIUS, OUR CHIEF EXECUTIVE OFFICER, OR MONTY R. SCHMIDT, OUR CHIEF TECHNOLOGY OFFICER, OUR BUSINESS MAY BE HARMED.

Our success will depend on our senior executives. In particular, the loss of the services of our Chief Executive Officer, Rimas P. Buinevicius, or our co-founder and Chief Technology Officer, Monty R. Schmidt, would harm our business. Although we have long-term employment agreements with Messrs. Buinevicius and Schmidt, we do not have life insurance policies on any of our senior executives.

WE FACE RISKS ASSOCIATED WITH GOVERNMENT REGULATION OF THE INTERNET, AND RELATED LEGAL UNCERTAINTIES.

Currently, few existing laws or regulations specifically apply to the Internet, other than laws generally applicable to businesses. Many Internet-related laws and regulations, however, are pending and may be adopted in the United States, in individual states and local jurisdictions and in other countries. These laws may relate to many areas that impact our business, including encryption, network and information security, and the convergence of traditional communication services, such as telephone services, with Internet communications, taxes and wireless networks. These types of regulations could differ between countries and other political and geographic divisions both inside and outside the United States. Non-U.S. countries and political organizations may impose, or favor, more and different regulation than that which has been proposed in the United States, thus furthering the complexity of regulation. In addition, state and local governments within the United States may impose regulations in addition to, inconsistent with, or stricter than federal regulations. The adoption of such laws or regulations, and uncertainties associated with their validity, interpretation, applicability and enforcement, may affect the available distribution channels for, and the costs associated with, our products and services. The adoption of such laws and regulations may harm our business.

CURRENT AND FUTURE ECONOMIC AND POLITICAL CONDITIONS MAY ADVERSELY AFFECT OUR BUSINESS.

Economic growth in the United States and throughout most of the world continues to be slow, though there are signs that at least in the U.S., economic growth may be increasing at a modestly higher rate than in the recent past. Nevertheless, it is still uncertain when economic conditions will improve on a sustained basis. In addition, the residual effects of war in Iraq, uncertainty about Iraq's political future and continuing tensions throughout the Middle East remain a risk to the domestic economy and may impact the supply and price of petroleum products, which may in turn negatively impact the world economy. Moreover, the prospect of future terrorist attacks in the United States and elsewhere may have a further negative impact on the economy. In particular, the technology and telecommunications sectors continue to languish in an economic downturn more pronounced than that of the broader U.S. and world economies. If economic conditions worsen because of economic, political or social turmoil or military conflict, or if there are further terrorist attacks in the United States or elsewhere, our customers may not be able to pay for our products and our distribution partners may cease operations, which may harm our operating results.

AN INVESTMENT IN OUR COMMON STOCK IS RISKY BECAUSE THE PRICE OF OUR STOCK HAS BEEN VOLATILE AND WE COULD BE DELISTED FROM THE NASDAQ NATIONAL MARKET.

Our common stock price, like that of many companies in the Internet industry, has been and may continue to be extremely volatile, and there is a risk we could be delisted from the NASDAQ National Market. The market price of our common stock has been and may continue to be subject to significant fluctuations as a result of variations in our quarterly operating results and volatility in the financial markets. Our stock traded below $1.00 in 2003, and we previously received notice from the NASDAQ National Market that we need to comply with the requirements for continued listing on the NASDAQ National Market or be delisted, although we have demonstrated compliance and the hearing file was closed. If our stock trades below $1.00 for 30 consecutive business days, we may receive another notice from the NASDAQ National Market that we need to comply with the requirements for continued listing on the NASDAQ National Market within 90 calendar days from such notification or be delisted. If our stock is delisted from the NASDAQ National Market, an investor could find it more difficult to dispose of, or to obtain accurate quotations as to the market value of, our common stock. Additionally, our stock may be subject to "penny stock" regulations. If our common stock were subject to "penny stock" regulations, which apply to certain equity securities not traded on the NASDAQ National Market which have a market price of less than $5.00 per share, subject to limited exceptions, additional disclosure would be required by broker-dealers in connection with any trades involving such penny stock.

EXERCISE OF OUTSTANDING OPTIONS AND WARRANTS WILL RESULT IN FURTHER DILUTION.

The issuance of shares of common stock upon the exercise of our outstanding options and warrants will result in dilution to the interests of our stockholders, and may reduce the trading price and market for our common stock.

At September 30, 2005, we had outstanding options and warrants to acquire 5.8 million shares of common stock, 1.0 million of which are subject to future vesting. Included in the foregoing are 4.6 million options which have been granted under our 1995 Employee Stock Option Plan, our 1999 Non-Qualified Stock Option Plan and our Non-Employee Director Stock Option Plan, 3.6 million of which are immediately exercisable.

To the extent that these stock options or warrants are exercised, the dilution to the interests of our stockholders will likely occur. Additional options and warrants may be issued in the future at prices not less than 85% of the fair market value of the underlying security on the date of grant. Exercise of these options or warrants, or even the potential of their exercise may have an adverse effect on the trading price and market for our common stock. The holders of our options or our warrants are likely to exercise them at times when the market price of the common stock exceeds the exercise price of the securities. Accordingly, the issuance of shares of common stock upon exercise of the options and warrants will likely result in dilution of the equity represented by the then outstanding shares of common stock held by other stockholders. Holders of our options and warrants can be expected to exercise or convert them at a time when we would, in all likelihood, be able to obtain any needed capital on terms, which are more favorable to us than the exercise terms provided, by these options and warrants.

WE MAY NEED TO MAKE ACQUISITIONS OR FORM STRATEGIC ALLIANCES OR PARTNERSHIPS IN ORDER TO REMAIN COMPETITIVE IN OUR MARKET, AND POTENTIAL FUTURE ACQUISITIONS, STRATEGIC ALLIANCES OR PARTNERSHIPS COULD BE DIFFICULT TO INTEGRATE, DISRUPT OUR BUSINESS AND DILUTE STOCKHOLDER VALUE.

We may acquire or form strategic alliances or partnerships with other businesses in the future in order to remain competitive or to acquire new technologies. As a result of these acquisitions, strategic alliances or partnerships, we may need to integrate products, technologies, widely dispersed operations and distinct corporate cultures. The products, services or technologies of the acquired companies may need to be altered or redesigned in order to be made compatible with our software products and services, or the software architecture of our customers. These integration efforts may not succeed or may distract our management from operating our existing business. Our failure to successfully manage future acquisitions, strategic alliances or partnerships could seriously harm our operating results. In addition, our stockholders would be diluted if we finance the acquisition, strategic alliances or partnerships by incurring convertible debt or issuing equity securities.

OUR CURRENT STOCK COMPENSATION EXPENSE NEGATIVELY IMPACTS OUR EARNINGS AND ONCE WE ARE REQUIRED TO REPORT THE FAIR VALUE OF EMPLOYEE STOCK OPTIONS AS AN EXPENSE IN CONJUNCTION WITH FINANCIAL ACCOUNTING STANDARDS BOARD STATEMENT NO. 123(R) – SHARE BASED PAYMENT, OUR EARNINGS WILL BE ADVERSELY AFFECTED, WHICH MAY CAUSE OUR STOCK PRICE TO DECLINE.

Under our current accounting practice, stock compensation is recorded on the date of grant only if the current market price of the underlying stock exceeds the exercise price. Had we accounted for our stock option plans based upon the fair value at the grant date for options granted under the plans, based on the provisions of SFAS 123, our net income (loss) would have been reduced by $522, $360 and $305 thousand of compensation expense in the years ended September 30, 2005, 2004 and 2003. Effective October 1, 2005, we will be required to record compensation expense in the financial statements for stock issued to employees based on the grant date fair value of the equity issued. The adoption of SFAS 123(R)'s fair value method may have a significant impact on our results of operations and as such, our ability to achieve or maintain profitability may be negatively impacted, which may cause our stock price to decline.

OUR CORPORATE COMPLIANCE PROGRAM CANNOT GUARANTEE THAT WE ARE IN COMPLIANCE WITH ALL POTENTIALLY APPLICABLE REGULATIONS.

As a publicly traded company we are subject to significant regulations, including the Sarbanes-Oxley Act of 2002, some of which have either only recently been adopted or are currently proposals subject to change. While we have developed and instituted a corporate compliance program based on what we believe are the current best practices and continue to update the program in response to newly implemented or changing regulatory requirements, we cannot assure that we are or will be in compliance with all potentially applicable regulations. For example, we cannot assure that in the future our management will not find a material weakness in connection with its annual review of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act, effective for fiscal year 2007. We also cannot assure that we could correct any such weakness to allow our management to assess the effectiveness of our internal control over financial reporting as of the end of our fiscal year in time to enable our independent registered public accounting firm to attest that such assessment will have been fairly stated in our Annual Report on Form 10-K to be filed with the Securities and Exchange Commission or attest that we have maintained effective internal control over financial reporting as of the end of our fiscal year. If we fail to comply with any of these regulations, we could be subject to a range of regulatory actions, fines, or other sanctions or litigation. In addition, if we must disclose any material weakness in our internal control over financial reporting, this may cause our stock price to decline.

WE ARE SUBJECT TO RISKS ASSOCIATED WITH GOVERMENTAL REGULATION AND LEGAL UNCERTAINTIES.

It is likely that a number of laws and regulations may be adopted in the United States and other countries with respect to the Internet that might affect us. Those laws may relate to areas such as:

- changes in telecommunications regulations;
- copyright and other intellectual property rights;
- encryption;
- personal privacy concerns, including the use of "cookies" and individual user information;
- e-commerce liability;
- email, network and information security.

Changes in telecommunications regulations could substantially increase the costs of communicating on the Internet or over VoIP networks. This, in turn, could slow the growth in the internet use of VoIP networks and thereby decrease the demand for our services. Several telecommunications carriers are advocating that the Federal Communications Commission regulate the Internet and VoIP networks in the same manner as other telecommunications services by imposing access fees. Recent events suggest that the FCC may begin regulating the Internet and VoIP networks in such a way. In addition, we operate our services throughout the United States and state regulatory authorities may seek to regulate aspects of our services as telecommunications activities.

Other countries and political organizations are likely to impose or favor more and different regulations than those that have been proposed in the United States, thus furthering the complexity of the regulation. The adoption of such laws or regulations, and uncertainties associated with their validity and enforcement, may affect the available distribution channels for and costs associated with our services, and may affect the growth of the Internet or VoIP networks. Such laws or regulations may therefore harm our business.

PROVISIONS OF OUR CHARTER DOCUMENTS AND MARYLAND LAW COULD ALSO DISCOURAGE AN ACQUISITION OF OUR COMPANY THAT WOULD BENEFIT OUR STOCKHOLDERS.

Provisions of our articles of incorporation and by-laws may make it more difficult for a third party to acquire control of our company, even if a change in control would benefit our stockholders. Our articles of incorporation authorize our board of directors, without stockholder approval, to issue one or more series of preferred stock, which could have voting and conversion rights that adversely affect or dilute the voting power of the holders of common stock. Furthermore, our articles of incorporation provide for classified voting, which means that our stockholders may vote upon the retention of only one or two of our seven directors each year. Moreover, Maryland corporate law restricts certain business combination transactions with "interested stockholders."

## ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable

## ITEM 2. PROPERTIES

Our principal office is located in Madison, Wisconsin in a leased facility of approximately 11,000 square feet. The building serves as our corporate headquarters, accommodating our General and Administrative, Research and Development and Sales and Marketing departments. We believe this facility is adequate and suitable for our needs. The initial lease term for this office expires on October 1, 2008. In addition, we lease 2,000 square feet in a building in downtown Pittsburgh, Pennsylvania on a month-to-month basis.

## ITEM 3. LEGAL PROCEEDINGS

None

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

The Annual Meeting of Stockholders was held on May 12, 2005. A quorum consisting of approximately 88.8% of the Company's common stock issued and outstanding was represented either in person or by proxy. At the meeting the following proposals were approved by the stockholders:

1. To elect Arnold B. Pollard as Class II Director. Frederick H. Kopko, Jr, Rimas P. Buinevicius, Monty R. Schmidt, Gary R. Weis, David C. Kleinman and Paul S. Peercy continued as directors following the meeting.

2. To ratify the appointment of Grant Thornton LLP as independent auditors of Sonic Foundry for the year ending September 30, 2005.

| | For | Against | Abstain/Withheld |
|---|---|---|---|
| Proposal #1: | | | |
| Arnold B. Pollard | 26,486,046 | | 306,832 |
| Proposal #2 | 26,658,753 | 59,100 | 75,025 |

# PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock was initially traded on the American Stock Exchange under the symbol "SFO," beginning with our initial public offering in April of 1998. On April 24, 2000, our common stock began trading on the Nasdaq National Market under the symbol "SOFO." The following table sets forth, for the periods indicated, the high and low sale prices per share of our common stock as reported on the Nasdaq National Market.

| | **High** | **Low** |
|---|---|---|
| **Year Ended September 30, 2006:** | | |
| First Quarter (through December 5, 2005) | $ 1.34 | $ 1.03 |
| **Year Ended September 30, 2005:** | | |
| First Quarter | 1.85 | 1.32 |
| Second Quarter | 1.65 | 1.14 |
| Third Quarter | 1.45 | 1.05 |
| Fourth Quarter | 1.45 | 1.10 |
| **Year Ended September 30, 2004:** | | |
| First Quarter | 2.72 | 1.70 |
| Second Quarter | 2.68 | 1.81 |
| Third Quarter | 2.51 | 1.20 |
| Fourth Quarter | 1.71 | 1.26 |

In October 2002, our common stock failed to maintain a minimum bid price of $1.00 per share for at least 30 consecutive days, which caused our stock price to fail to meet one of the minimum standards required by the Nasdaq Stock Market for continued listing as a Nasdaq National Market Security. We requested a hearing before a Nasdaq Listing Qualifications Panel to review the Staff Determination and made a presentation on February 27, 2003. At the hearing, we asked for and later received continued listing while pursuing the sale of the Desktop Software and Media Service business transactions. On June 27, 2003 we received a letter from a Nasdaq listing qualifications official indicating compliance with the minimum closing bid price requirement and that the hearing file was closed.

The Company has not paid any cash dividends and does not intend to pay any cash dividends in the foreseeable future.

At December 5, 2005 there were 517 common stockholders of record. Many shares are held by brokers and other institutions on behalf of shareholders.

**Equity Compensation Plan Information**

| Plan category | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance |
|---|---|---|---|
| | (a) | (b) | (c) |
| Equity compensation plans approved by security holders (1) | 2,409,959 | $ 3.29 | 3,168,648 |
| Equity compensation plans not approved by security holders (2) | 2,177,805 | 1.17 | 603,475 |
| Total | 4,587,764 | $ 2.28 | 3,772,123 |

(1) Consists of Employee Stock Option Plan and the Directors Stock Option Plan. For further information regarding these plans, reference is made to Note 5 of the financial statements.
(2) Consists of the Non-Qualified Stock Option Plan. For further information regarding this plan, reference is made to Note 5 of the financial statements.

**RECENT SALES OF UNREGISTERED SECURITIES**

None

**(B) USE OF PROCEEDS FROM REGISTERED SECURITIES**

None

**(C) ISSUER PURCHASES OF EQUITY SECURITIES**

None

## ITEM 6. SELECTED FINANCIAL DATA

The selected financial and operating data were derived from financial statements audited by Grant Thornton LLP as of and for the years ended September 30, 2005 and 2004 and by Ernst & Young LLP as of and for the years ended September 30, 2003, 2002, and 2001. The selected financial data set forth below is qualified in its entirety by, and should be read in conjunction with, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and notes thereto appearing elsewhere in this annual report on Form 10-K (in thousands except per share data).

| | Years Ended September 30, | | | | |
|---|---|---|---|---|---|
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| **Statement of Operations Data:** | | | | | |
| Revenue | $ 8,342 | $ 4,413 | $ 1,264 | $ 859 | $ — |
| Gross margin | 5,588 | 2,654 | 376 | 479 | — |
| Loss from operations | (4,356) | (5,607) | (7,530) | (7,876) | (2,624) |
| Loss from continuing operations before cumulative effect of change in accounting principle | (4,169) | (5,508) | (7,549) | (8,314) | (2,085) |
| Loss from operations of discontinued operations | — | — | (2,930) | (3,691) | (47,775) |
| Gain on disposal of discontinued operations | — | 132 | 11,932 | — | — |
| Cumulative effect of change in accounting principle | — | — | — | (44,732) | — |
| Net income (loss) | (4,169) | (5,376) | 1,453 | (56,737) | (49,860) |
| Income (loss) per common share before cumulative effect of change in accounting principle: | | | | | |
| Continuing operations | $ (0.14) | $ (0.18) | $ (0.27) | $ (0.31) | $ (0.09) |
| Discontinued operations | — | — | 0.32 | (0.14) | (2.16) |
| Cumulative effect of change in accounting principle | — | — | — | (1.67) | — |
| Basic net income (loss) per common share | $ (0.14) | $ (0.18) | $ 0.05 | $ (2.12) | $ (2.25) |
| Diluted net income (loss) per common share | $ (0.14) | $ (0.18) | $ 0.05 | $ (2.12) | $ (2.25) |
| Weighted average common shares: - Basic | 30,363 | 29,457 | 27,794 | 26,812 | 22,129 |
| - Diluted | 30,363 | 29,457 | 28,375 | 26,812 | 22,129 |

| **Balance Sheet Data at September 30:** | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| Cash and cash equivalents | $ 4,271 | $ 7,583 | $ 12,623 | $ 3,704 | $ 7,809 |
| Working capital (deficit) | 4,205 | 7,560 | 11,025 | (496) | 4,421 |
| Total assets | 16,245 | 18,631 | 22,801 | 27,643 | 71,683 |
| Total indebtedness | 43 | — | 48 | 5,263 | 5,961 |
| Stockholders' equity | 13,121 | 16,566 | 20,231 | 17,984 | 61,231 |

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The financial and business analysis below provides information that the Company believes is relevant to an assessment and understanding of the Company's consolidated financial position and results of operations. This financial and business analysis should be read in conjunction with the consolidated financial statements and related notes.

When used in this Report, the words “anticipate”, “expects”, “plans”, “believes”, “seeks”, “estimates” and similar expressions are intended to identify forward-looking statements. These are statements that relate to future periods and include, but are not limited to, statements about the features, benefits and performance of our Rich Media products, our ability to introduce new product offerings and increase revenue from existing products, expected expenses including those related to sales and marketing, research and development and general and administrative, our beliefs regarding the health and growth of the market for Rich Media products, anticipated increase in our customer base, expansion of our products functionalities, expected revenue levels and sources of revenue, expected impact, if any, of legal proceedings, the adequacy of liquidity and capital resources, and expected growth in business. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, market acceptance for our products, our ability to attract and retain customers and distribution partners for existing and new products, our ability to control our expenses, our ability to recruit and retain employees, the ability of distribution partners to successfully sell our products, legislation and government regulation, shifts in technology, global and local business conditions, our ability to effectively maintain and update our products and service portfolio, the strength of competitive offerings, the prices being charged by those competitors, and the risks discussed elsewhere herein. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

### Overview

Our business develops automated rich media applications and scalable solutions that allow media owners--including educational institutions, corporations and government organizations--to deploy, manage, index and distribute video content on Internet-based networks. Our core product is the family of Mediasite presentation recorders (“Mediasite”), complete presentation recording systems for live or on-demand viewing over the Internet, intranet or recording to physical media. Related products and services include server software applications, hosting services, and customer support, installation and training services. Mediasite addresses a broad variety of communications ranging from executive briefings, product marketing, and sales presentations to public safety/emergency management and community outreach, to online lectures and distance learning.

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; and
- Valuation allowance for net deferred tax assets.

*Revenue Recognition and Allowance for Doubtful Accounts*

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, and does not offer price protection, rebates and other offerings that occur under sales programs and accordingly does not reduce revenue for such programs. 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 but excludes revenue generated from customer support services, which is included in customer support fees discussed below.

Customer Support Fees

We sell support contracts to our Mediasite customers, typically one year in length and record the related revenue ratably over the contractual period. We also sell installation and training services and host customer Mediasite content. Revenue for those services is recognized when performed in the case of installation and training services and are recognized ratably over the contract period for hosting services. 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. Revenue for time and material contracts such as training fees are recognized as services are rendered. Service amounts invoiced to customers in excess of revenue recognized are recorded as deferred revenue until the revenue recognition criteria are met.

Other

Other revenue consists of software licensing of our Publisher product, custom software development performed under time and materials or fixed fee arrangements and amounts charged for 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. Custom software development includes fees recorded pursuant to long-term contracts (including research grants), using the percentage of completion method of accounting, when significant customization or modification of a product is required. 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, and support agreements is allocated to each element based on its relative fair value and recognized for each element when the revenue recognition criteria have been met for such element. Fair value is generally determined based on the price charged when the element is sold separately. In the absence of fair value of a delivered element, 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.

Credit Evaluation

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

*Impairment of long-lived assets*

We assess the impairment of goodwill and capitalized software development costs on an annual basis or whenever events or changes in circumstances indicate that the fair value of these assets is less than the carrying value. 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". We evaluate all of our long-lived assets and intangible assets, including intangible assets other than goodwill, for impairment. Long-lived assets and intangible assets other than goodwill are evaluated for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on expected undiscounted cash flows attributable to that asset. Should events indicate that any of our long-lived assets are impaired; the amount of such impairment will be measured as the difference between the carrying value and the fair value of the impaired asset and recorded in earnings during the period of such impairment.

*Valuation allowance for net deferred tax assets*

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

## RESULTS OF OPERATIONS

Our Rich Media business was established in fiscal 2002 upon the acquisition of Mediasite Inc. in October 2001. Our Media Services and Desktop Software businesses were sold in fiscal 2003 and reported under the caption of discontinued operations. The sale of our Media Services and Desktop Software businesses significantly affects the comparability of our results of operations from year to year. You should read the following discussion of our results of operations and financial condition in conjunction with our consolidated financial statements and related notes thereto included in Item 8 of this Annual Report on Form 10-K.

### Revenue

Revenues from our business include the sales of Mediasite and server software products and related customer support contracts and services, such as content hosting, sold separately as well as fees charged for the licensing of indexing related software and custom software development. We market our products to educational institutions, corporations and government agencies that need to deploy, manage, index and distribute video content on Internet-based networks. We reach both our domestic and international markets through reseller networks, a direct sales effort and partnerships with system Integrators.

**2005 compared to 2004**

Revenues in 2005 totaled \$8.3 million, compared to \$4.4 million in 2004. Revenues consisted of the following:

- Product sales of Mediasite increased from $3.4 million in 2004 to $6.9 million in 2005 due to many factors including increased sales and marketing efforts, multiple unit sales, repeat purchases from existing customers (44% of 2005 revenues were from preexisting customers compared to 35% in 2004), addition of our server software product, release of new versions of Mediasite and product enhancements.

| | 2005 | 2004 |
|---|---|---|
| Units sold | 467 | 269 |
| Mobile to rack ratio | 1.5 to 1 | 2.5 to 1 |
| Average sales price, excluding support (000's) | $14.8 | $12.8 |
| Mediasite gross margins, excluding support | 66% | 60% |

- Customer support revenue represents the portion of fees charged for Mediasite SmartServe service contracts amortized over the length of the contract, typically 12 months, as well as training and installation services. Customer support revenue increased from $425 thousand in 2004 to $975 thousand in 2005, due primarily to support contracts on an increasing number of new Mediasite sales as well as renewals of support contracts entered into in prior years. At September 30, 2005 $957 thousand of unrecognized support revenue remained in unearned revenues, of which we expect to recognize $320 thousand in the upcoming quarter.
- Other revenue relates to freight charges billed separately to our customers, software licensing fees for our Publisher product and certain custom software engineering projects
  - In 2005, we recorded revenue of $163 thousand, in a single transaction, for the license of software code designed for indexing of rich media and video filters.
  - Other revenues also include $221 thousand of grant revenue in 2005 compared to $245 thousand in 2004, pursuant to a $496 thousand grant awarded by the Department of Justice in October 2003. We expect to complete the grant in 2006 and recognize the remaining $30 thousand available under the contract. We do not expect to request additional funds to further advance the technology.

**2004 compared to 2003**

Revenue increased $3.1 million, from $1.3 million in 2003 to $4.4 million in 2004.

- Product sales of Mediasite increased from $1.2 million in 2003 to $3.4 million in 2004 due to many factors including increases in internal and external sales and marketing efforts, demand generated from prior sales to high profile reference accounts, repeat purchases from existing customers and product enhancements.
- Customer support revenue increased from $84 thousand in 2003 to $425 thousand in 2004, due primarily to increased sales of new Mediasite products and renewals of support contracts entered into in 2003. At September 30, 2004, $473 thousand of unrecognized support revenues remained in unearned revenues.
- Other revenue relates to freight charges billed separately to our customers, software licensing fees for our Publisher product and certain custom software engineering projects. Other than freight costs, no other revenues were recorded in 2003.
  - In 2004 we recorded Publisher license revenues of $242 thousand from a system integrator selling to a unit of the Federal Government. The amount represents the second phase of a transaction originally entered into in fiscal 2002.
  - Other revenues also include $245 thousand of grant revenue pursuant to a $496 thousand grant awarded by the Department of Justice in October 2003.

**Gross Margin**

Total gross margins for 2005 were $5.6 million or 67% compared to $2.7 million or 60% in 2004. High margin customer support revenue and licensing of server software applications accounted for the majority of the increase in gross margin percentage over 2004 levels. The significant components of cost of systems include:

- Material and freight costs for the Mediasite units. The gross margin on Mediasite sales varies with product mix; our rack units typically carry a higher margin than our mobile units do. Mediasite customer support revenues, hosting services, server license fees and DOJ grant revenue do not carry a cost over and above staff costs included in operating expenses – significantly enhancing Mediasite product margins. Mediasite sales should typically result in gross margins of approximately 60% - 70%.

- Amortization of Mediasite Inc. related acquisition amounts assigned to purchased technology and other identified intangibles. We will continue to amortize approximately $83 thousand per quarter over the next year for the identified intangibles of the purchase.
- In late 2005 we began to amortize the capitalized costs for the design of tooling to make our own system components. We expect additional amortization expense of approximately $220 over the next year.
- No royalty fees on Publisher revenues were incurred in fiscal 2005 nor do we expect to incur any significant payments in the future.

Margins are expected to continue to increase in the near term as total revenues increase, non-cash amortization of purchased technology costs remain constant, and as the mix of revenues reflects a greater percentage of higher margin post contract support, server software license fees, consulting and hosting revenues.

### 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.

#### 2005 compared to 2004

The $1.45 million increase in sales and marketing expense from 2004 to 2005 resulted from numerous items. Significant differences include:

- Growth in revenues and sales staff led to an increase of $1.2 million in wages, commissions, benefits, travel and related administrative costs. Our sales staff increased from 20 to 31.
- $250 thousand increase in advertising and tradeshow expense due to additional tradeshow attendance and increased print advertising.

As of September 30, 2005 we had 31 employees in Selling, Marketing and Customer Support, an increase of 11 employees from 2004. We anticipate approximately 40% growth in selling and marketing headcount in fiscal 2006.

#### 2004 compared to 2003

Selling and marketing expenses increased by $851 thousand, or 27%, to $3.8 million in 2004 from $3.0 million in 2003, primarily attributable to the following:

- $600 thousand increase in wages, commissions, benefits, travel and related administrative costs associated with an increase in field sales staff from 6 to 14. The increase was partially offset by a decrease in severance related wages of $300 thousand paid to two sales executives in 2003.
- $270 thousand increase in advertising, promotional and tradeshow expenses in 2004 over 2003 primarily directed at promoting new product versions and introducing products to new markets.
- Mediasite units used by sales, training and support staff were expensed in 2004 when removed from inventory as well as units used as “loaners” to key accounts for 30 to 90 day trial periods. The cost of internal and loaner units in 2004 was $192 thousand.

### General and Administrative Expenses ("G&A 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.

**2005 compared to 2004**

G&A expenses increased $40 thousand, or 1%, from $2.82 million in 2004 to $2.86 million in 2005. Major components of the change include:

- Wage and benefit expenses increased nearly $170 thousand due in part to non-cash stock compensation associated with the separation of an employee, annual wage and incentive increases, and increased cost of benefits.
- This increase was partially offset as we utilized available credits to reduce certain retirement and other expenses by over $110 thousand.
- Other variances included an increase in facility expense due in part to increased square footage under lease, and a decrease in professional fees including accounting and legal services.

As of September 30, 2005 we had 8 full-time employees in G&A. We do not anticipate significant growth in G&A headcount in fiscal 2006.

**2004 compared to 2003**

G&A expenses decreased $363 thousand, or 11%, from $3.2 million in 2003 to $2.8 million in 2004. The decrease is due to:

- A $300 thousand charge to accrue the remaining anticipated net costs through the date of lease expiration for two Pittsburgh, PA facilities no longer utilized.
- $250 thousand reduction in professional fees primarily related to 2003 legal fees associated with debt and other restructuring activities.
- Increase in facility and other operating costs associated with increase in product shipments.

**Product Development Expenses ("R&D 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.

**2005 compared to 2004**

R&D expenses increased $194 thousand, or 12%, from $1.6 million in 2004 to $1.8 million in 2005. Salaries, commissions and benefits were the primary reason for the increase, accounting for $163 thousand of the increase over the prior year. Additional contributors to the increase included facilities related expenses. In 2005, 79% of R&D costs related to salaries and benefits.

As of September 30, 2005 we had 15 employees in Research and Development. We do not anticipate significant growth in R&D headcount in fiscal 2006. We do not anticipate that any fiscal 2005 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.”

**2004 compared to 2003**

R&D expenses decreased $133 thousand, or 8%, from $1.7 million in 2003 to $1.6 million in 2004. Attrition and workforce reductions of Publisher focused engineering staff at our Pittsburgh, PA location, partially offset by an increase in Madison, WI based Mediasite focused engineering staff accounted for the change.

### Other Income (Expense)

Other income (expense) included primarily interest income in 2005 and 2004, and a loss on sale of miscellaneous equipment in 2003.

### Discontinued Operations

*Media Services*

The Company completed the sale of assets utilized in the Media Services business on May 16, 2003 with Deluxe Media Services ("Deluxe"). The transaction included all assets utilized in the Company's Media Services business primarily affecting business conducted from and employees in the Company's Santa Monica California and Toronto Canada facilities. Under terms of the agreement, Deluxe acquired the Media Services business for approximately $5.6 million including cash of $4.5 million plus an estimate of $1.1 million for net working capital and assumption of certain capital leases. The Company received $5.2 million at close with the remainder due upon the final determination of actual working capital. The Company received $350 thousand of the remainder in September 2003 and received a final payment of $241 thousand in January 2004. The Company recorded a gain on sale of discontinued operations of $185 thousand in 2004 to reflect the amount that the January 2004 payment and other settlements exceeded the working capital estimates. Overall, the Company recorded a loss on disposition of the Media Services business of $1.8 million.

The 2003 loss from operations of discontinued operations includes a $1.8 million loss related to the Media Services business, on revenues of $4.9 million.

*Desktop Software*

The Company entered into an amended and restated asset purchase agreement with SP Acquisition Company, a subsidiary of Sony Pictures Digital, dated June 6, 2003 and effective May 2, 2003, to sell the assets of the Company's Desktop Software business for $19 million cash and assumption of certain trade payables, accrued liabilities and capital leases associated with the Desktop Software business. The transaction was completed on July 30, 2003. The negotiated price of the transaction contemplated net working capital balances at March 31, 2003 with any difference between the values at March 31, 2003 and the date of close to be reflected as a post closing adjustment. The Company's net working capital decreased during the period preceding close due to improved collections of customer accounts, leading to an adjustment in the purchase price of $497 thousand which was paid to Sony Pictures Digital in December 2003. The Company recorded a gain on the disposal of the Desktop Software business in fiscal 2003 of $13.9 million and recorded a $53 thousand loss in 2004 to account for the final settlement of working capital.

The 2003 loss from operations of discontinued operations includes a $1.1 million loss related to the Desktop Software business, on revenues of $12.0 million.

## LIQUIDITY AND CAPITAL RESOURCES

We have funded our operations to date primarily from public and private placement offerings of equity securities, debt, and from the 2003 sales of our Desktop Software and Media Services businesses. On September 30, 2005, 2004 and 2003, we had cash and cash equivalents of $4.3, $7.6 and $12.6 million.

**2005 compared to 2004**

Cash used in operating activities totaled $3.3 million in 2005 compared to $6.2 million in 2004. The decrease in cash outflows related to a $1.2 million reduction in net loss, and reduced cash requirements in accounts payable and accrued liabilities. These factors were partially offset by an increase in accounts receivable due to increased Mediasite revenues in 2005.

Cash used in investing activities totaled $435 thousand in 2005 compared to cash used in investing activities of $271 thousand in 2004. Investing activities for the current year were due to the purchases of property and equipment. Investing activities in the prior year were due to purchases of property and equipment as well, net of an additional $132 thousand proceeds received from the sale of discontinued businesses.

Cash provided by financing activities in 2005 totaled $470 thousand compared to $1.5 million in 2004. Current year financing activities included $470 thousand of issuance of common stock from exercise of common stock purchase options and warrants while the prior year included $1.5 million of such proceeds, partially offset by capital lease payments.

### 2004 compared to 2003

Cash used in operating activities totaled $6.2 million in 2004 compared to $4.1 million in 2003. Increases in Mediasite revenues in 2004 resulted in increased accounts receivable and inventories of nearly $1.0 million whereas accounts receivable declined in 2003 by $819 thousand due to the impending sales of the Desktop Software and Media Services businesses.

Cash used in investing activities totaled $271 thousand in 2004 compared to cash provided by investing activities of $20.9 million in 2003. Investing activities for 2004 were due to purchases of property and equipment, net of an additional $132 thousand proceeds received from the sale of discontinued businesses in 2003.

Cash provided by financing activities in 2004 totaled $1.5 million compared to a use of cash of $7.9 million in 2003. The year 2004 included $1.5 million of proceeds from issuance of common stock.

We expect to reach cash flow breakeven in fiscal 2006 and believe we can fund operations with cash on hand through that point. Despite our belief that we have sufficient cash to fund operations in 2006, we believed it was prudent to raise additional cash through the issuance of common stock. In November 2005, we issued 747 thousand shares and 149 thousand common stock purchase warrants to certain individual investors, and received proceeds of $725 thousand.

We expect to continue to acquire property and equipment in fiscal 2006 including equipment associated with our anticipated growth in employees, expansion of our services offering and development of a new hardware component in our Mediasite product. We have no plans to pursue any debt arrangements at this time but may evaluate further operating or capital lease opportunities to finance certain equipment acquisitions. In order to fund long-term cash requirements and/or pursue complimentary business strategies, we may evaluate the issuance of additional stock to investors or strategic partners.

### Contractual Obligations

The following summarizes our contractual obligations at September 30, 2005 and the effect those obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

| Contractual Obligations: | Total | Less than 1 Year | Years 2-3 | Years 4-5 | Over 5 years |
|---|---|---|---|---|---|
| Purchase commitments | $ 1,624 | $ 1,624 | $ — | $ — | $ — |
| Operating lease obligations | 668 | 216 | 451 | 1 | — |
| Capital lease obligations | 43 | 15 | 28 | — | — |

## ITEM 7A. 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.

### Foreign Currency Exchange Rate Risk

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

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Sonic Foundry, Inc.

We have audited the accompanying consolidated balance sheets of Sonic Foundry, Inc. (the Company) as of September 30, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. The consolidated financial statements of the Company for the year ended September 30, 2003, were audited by other auditors. Those auditors expressed an unqualified opinion on those consolidated financial statements in their report dated November 14, 2003.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audits of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of September 30, 2005 and 2004 and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Schedule II, listed in the Index at Item 15(a) is presented for purposes of additional analysis and is not a required part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

**GRANT THORNTON LLP**

Madison, Wisconsin
November 4, 2005

Report of Ernst & Young LLP, Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Sonic Foundry, Inc.

We have audited the accompanying consolidated statement of operations, stockholders' equity and cash flows of Sonic Foundry, Inc. (the Company) for the year ended September 2003. Our audit also included the financial statement schedule listed in the index at Item 15(a) for the year ended September 30, 2003. The financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated results of the Company's operations and its cash flows for the year ended September 30, 2003, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

**ERNST & YOUNG LLP**

Milwaukee, Wisconsin
November 14, 2003

**Sonic Foundry, Inc.**
**Consolidated Balance Sheets**
**(in thousands except for share data and per share data)**

| | September 30, 2005 | September 30, 2004 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 4,271 | $ 7,583 |
| Accounts receivable, net of allowances of $115 and $98 | 2,232 | 1,345 |
| Inventories | 414 | 371 |
| Prepaid expenses and other current assets | 363 | 299 |
| Total current assets | 7,280 | 9,598 |
| Property and equipment: | | |
| Leasehold improvements | 185 | 185 |
| Computer equipment | 1,570 | 1,010 |
| Furniture and fixtures | 185 | 177 |
| Total property and equipment | 1,940 | 1,372 |
| Less accumulated depreciation | 933 | 627 |
| Net property and equipment | 1,007 | 745 |
| Other assets: | | |
| Goodwill and other intangible assets, net | 7,626 | 7,676 |
| Capitalized software development costs, net of amortization of $1,067 and $788 | 332 | 612 |
| Total other assets | 7,958 | 8,288 |
| **Total assets** | $ 16,245 | $ 18,631 |
| **Liabilities and stockholders' equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 1,323 | $ 879 |
| Accrued liabilities | 780 | 686 |
| Unearned revenue | 957 | 473 |
| Current portion of capital lease obligation | 15 | — |
| Total current liabilities | 3,075 | 2,038 |
| Long-term portion of capital lease | 28 | — |
| Other liabilities | 21 | 27 |
| Total liabilities | 3,124 | 2,065 |
| Stockholders' equity: | | |
| Preferred stock, $.01 par value, authorized 5,000,000 shares; none issued | — | — |
| 5% preferred stock, Series B, voting, cumulative, convertible, $.01 par value (liquidation preference at par), authorized 10,000,000 shares, none issued | — | — |
| Common stock, $0.01 par value, authorized 100,000,000 shares; 30,910,409 and 29,782,269 shares issued and 30,840,159 and 29,712,019 shares outstanding | 309 | 298 |
| Additional paid-in capital | 170,083 | 169,383 |
| Accumulated deficit | (157,077) | (152,908) |
| Receivable for common stock issued | (26) | (39) |
| Treasury stock, at cost, 70,250 shares | (168) | (168) |
| Total stockholders' equity | 13,121 | 16,566 |
| **Total liabilities and stockholders' equity** | $ 16,245 | $ 18,631 |

See accompanying notes

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

| | Years Ended September 30, | | |
|---|---|---|---|
| **Continuing Operations** | **2005** | **2004** | **2003** |
| **Revenue:** | | | |
| Product sales | $ 6,928 | $ 3,443 | $ 1,172 |
| Customer support fees | 975 | 425 | 84 |
| Other | 439 | 545 | 8 |
| Total revenue | 8,342 | 4,413 | 1,264 |
| Cost of revenue | 2,754 | 1,759 | 888 |
| **Gross margin** | 5,588 | 2,654 | 376 |
| | | | |
| **Operating expenses:** | | | |
| Selling and marketing expenses | 5,277 | 3,826 | 2,975 |
| General and administrative expenses | 2,864 | 2,826 | 3,189 |
| Product development expenses | 1,803 | 1,609 | 1,742 |
| Total operating expenses | 9,944 | 8,261 | 7,906 |
| **Loss from operations** | (4,356) | (5,607) | (7,530) |
| | | | |
| Other income (expense), net | 187 | 99 | (19) |
| **Loss from continuing operations** | (4,169) | (5,508) | (7,549) |
| | | | |
| Loss from operations of discontinued operations including $68 of income tax benefit in 2003 | — | — | (2,930) |
| Gain on disposal of discontinued operations | — | 132 | 11,932 |
| **Net income (loss)** | $ (4,169) | $ (5,376) | $ 1,453 |
| | | | |
| **Income (loss) per common share:** | | | |
| Continuing operations | $ (0.14) | $ (0.18) | $ (0.27) |
| Discontinued operations | — | — | 0.32 |
| Basic net income (loss) per common share | $ (0.14) | $ (0.18) | $ 0.05 |
| Diluted net income (loss) per common share | $ (0.14) | $ (0.18) | $ 0.05 |
| | | | |
| Weighted average common shares – Basic | 30,363,000 | 29,457,000 | 27,794,000 |
| – Diluted | 30,363,000 | 29,457,000 | 28,375,000 |

See accompanying notes

# Sonic Foundry, Inc.
## Consolidated Statements of Stockholders' Equity
## For the Years Ended September 30, 2005, 2004 and 2003
## (in thousands)

| | Common stock | Additional paid-in capital | Accumulated deficit | Currency translations | Receivables for common stock issued | Unearned compen-sation | Treasury stock | Total |
|---|---|---|---|---|---|---|---|---|
| **Balance, September 30, 2002** | $ 277 | $ 167,028 | $ (148,985) | $ (111) | $ (26) | $ (49) | $ (150) | $ 17,984 |
| Issuance of common stock | 2 | 61 | — | — | — | — | — | 63 |
| Receipt of shares for retirement of debt | — | (10) | — | — | — | — | (18) | (28) |
| Issuance of common stock warrants and options | — | 224 | — | — | — | — | — | 224 |
| Exercise of common stock warrants and options | 8 | 803 | — | — | (436) | — | — | 375 |
| Amortization of unearned compensation | — | — | — | — | — | 49 | — | 49 |
| Comprehensive income: | | | | | | | | |
| Net income | — | — | 1,453 | — | — | — | — | 1,453 |
| Foreign currency translation adjustments | — | — | — | 111 | — | — | — | 111 |
| Comprehensive income | | | | | | | | 1,564 |
| **Balance, September 30, 2003** | 287 | 168,106 | (147,532) | — | (462) | — | (168) | 20,231 |
| Issuance of common stock | — | 13 | — | — | — | — | — | 13 |
| Issuance of common stock warrants and options | — | 194 | — | — | — | — | — | 194 |
| Exercise of common stock warrants and options | 11 | 1,070 | — | — | 423 | — | — | 1,504 |
| Net loss | — | — | (5,376) | — | — | — | — | (5,376) |
| **Balance, September 30, 2004** | 298 | 169,383 | (152,908) | — | (39) | — | (168) | 16,566 |
| Issuance of common stock warrants and options | — | 254 | — | — | — | — | — | 254 |
| Exercise of common stock warrants and options | 11 | 446 | — | — | 13 | — | — | 470 |
| Net loss | — | — | (4,169) | — | — | — | — | (4,169) |
| **Balance, September 30, 2005** | $ 309 | $ 170,083 | $ (157,077) | $ — | $ (26) | $ — | $ (168) | $ 13,121 |

See accompanying notes

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

| | Years Ended September 30, 2005 | 2004 | 2003 |
|---|---|---|---|
| **Operating activities** | | | |
| Net income (loss) | $ (4,169) | $ (5,376) | $ 1,453 |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | | |
| Gain on disposal of discontinued operations | — | (132) | (11,932) |
| Amortization of goodwill, other intangibles, and capitalized software development costs | 330 | 330 | 406 |
| Depreciation and amortization of property and equipment | 306 | 246 | 2,220 |
| Amortization of debt discount and debt issuance costs | — | — | 2,978 |
| Non-cash compensation charges and charges for stock warrants and options | 276 | 205 | 228 |
| Loss on sale of assets | — | — | 98 |
| Other non-cash items | (30) | — | — |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable, net | (876) | (716) | 819 |
| Inventories | (43) | (260) | (46) |
| Prepaid expenses and other assets | (97) | (78) | 164 |
| Accounts payable and accrued liabilities | 472 | (736) | (666) |
| Unearned revenue | 484 | 279 | 194 |
| Net cash used in operating activities | (3,347) | (6,238) | (4,084) |
| **Investing activities** | | | |
| Proceeds from sale of discontinued operations, net | — | 132 | 21,093 |
| Purchases of property and equipment | (435) | (403) | (250) |
| Proceeds from disposals of assets | — | — | 15 |
| Net cash provided by (used in) investing activities | (435) | (271) | 20,858 |
| **Financing activities** | | | |
| Proceeds from issuance of common stock, net of issuance costs | 470 | 1,517 | 438 |
| Proceeds from debt issuances | — | — | 1,069 |
| Payments on long-term debt and capital leases | — | (48) | (8,941) |
| Payments on line of credit, net | — | — | (451) |
| Net cash provided by (used in) financing activities | 470 | 1,469 | (7,885) |
| Effect of exchange rate changes on cash | — | — | 30 |
| Net increase (decrease) in cash and cash equivalents | (3,312) | (5,040) | 8,919 |
| Cash and cash equivalents at beginning of period | 7,583 | 12,623 | 3,704 |
| Cash and cash equivalents at end of period | $ 4,271 | $ 7,583 | $ 12,623 |
| Supplemental cash flow information: | | | |
| Interest paid | $ — | $ — | $ 1,004 |
| Income taxes paid (refunded) | 32 | (6) | (362) |
| Noncash transactions: | | | |
| Capital lease acquisitions | 43 | — | 33 |
| Property and equipment financed by accounts payable | 60 | — | — |
| Issuance of warrants for consulting services | 125 | 194 | 224 |
| Other non-cash items | 90 | — | — |

## 1. Basis of Presentation and Significant Accounting Policies

### *Business*

Sonic Foundry, Inc. (the Company) is in the business of developing automated rich media application software and systems (our "Rich Media" business). Our current operations were formed in October 2001 when we acquired the assets and assumed certain liabilities of Mediasite, Inc.

Until late fiscal 2003, we were engaged in three businesses – Media Services, Desktop Software and Rich Media. Media Services provided format conversion, tape duplication, film restoration and other services to the media, broadcast and entertainment industries. On May 16, 2003, the Company completed the sale of the Media Services business (see Note 2 –Discontinued Operations).

The desktop software business ("Desktop Software") designed, developed, marketed and supported software products for digitizing, converting, editing and publishing audio, video, and/or multimedia content. On July 30, 2003, the Company completed the sale of the Desktop Software business to a subsidiary of Sony Pictures Digital for approximately $19 million cash, certain other consideration, and assumption of certain accounts payable, accrued liabilities and capital leases associated with the Desktop Software business (see Note 2 – Discontinued Operations).

All revenue and expenses included in the results of operations of both the Media Services business and the Desktop Software business have been presented as discontinued operations (the "Discontinued Operations").

### *Principles of Consolidation*

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany transactions and balances have been eliminated. The functional currency of our foreign owned subsidiaries (whose operations were sold during 2003) was the Canadian dollar; accordingly, assets and liabilities were translated into United States dollars at the rate of exchange existing at the end of the period. Income and expense amounts were translated at the average exchange rates during the period. Adjustments resulting from translation were classified as a separate component of comprehensive income within stockholders' equity. In 2005 and 2004, net loss equaled comprehensive loss as there were no items of comprehensive income.

### *Use of Estimates*

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America (US GAAP), management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

### *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, and does not offer price protection, rebates and other offerings that occur under sales programs and, accordingly, does not reduce revenue for such programs. 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 but excludes revenue generated from customer support services, which is included in customer support fees discussed below.

Customer Support Fees

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 sell installation and training services and host customer Mediasite content. Revenue for those services is recognized when performed in the case of installation and training 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.

Other

Other revenue consists of software licensing of our Publisher product, custom software development performed under time and materials or fixed fee arrangements and amounts charged for 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. Custom software development includes fees recorded pursuant to long-term contracts (including research grants), using the percentage of completion method of accounting, when significant customization or modification of a product is required. 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 its relative fair value and recognized for each element when the revenue recognition criteria have been met for such element. Fair value is generally determined based on the price charged when the element is sold separately. In the absence of fair value of a delivered element, 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.

Shipping and Handling

Costs related to shipping and handling is included in cost of revenue for all periods presented.

Credit Evaluation and Customer Concentration

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. Billings for Mediasite product and support services to our two largest customers were each below 10% in 2005, and 11% each in 2004, while no individual customer was over 10% in 2003.

***Cash and Cash Equivalents***

For the purposes of the statement of cash flows, the Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

***Trade Accounts Receivable***

The majority of the Company's accounts receivable are due from companies in, or resellers to, the education industry. Credit is extended based on evaluation of a customer's financial condition and, generally, collateral is not required. Accounts receivable are due within 30 days and are stated at amounts due from customers net of an allowance for doubtful accounts. Accounts outstanding longer than the contractual payment terms are considered past due. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customer's current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes-off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts. Interest is not accrued on past due receivables.

***Inventory Valuation***

Inventory consists of raw materials and supplies used in the assembly of Mediasite units, work-in-process 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):

| | September 30, | |
|---|---|---|
| | 2005 | 2004 |
| Raw materials and supplies | $ 10 | $ 10 |
| Work in process | 38 | 72 |
| Finished goods | 366 | 289 |
| | $ 414 | $ 371 |

***Software Development Costs***

In 2002, the Company capitalized $1.4 million of software development related to the Mediasite Inc. transaction. Such costs are amortized by computing the greater of (a) the ratio that current gross revenues for the product bear to the total of current and anticipated future gross revenues or (b) the straight-line amortization over the remaining estimated economic useful life (five years) of the product. Capitalized software development costs are reported at the lower of unamortized cost or net realizable value. Capitalized software development costs at September 30, 2005 and 2004 are net of accumulated amortization of $1.07 million and $788 thousand, respectively.

***Property and Equipment***

Property and equipment are recorded at cost and are depreciated using the straight-line method for financial reporting purposes. The estimated useful lives used to calculate depreciation are as follows:

| | Years |
|---|---|
| Leasehold improvements | 5 to 10 years |
| Computer equipment | 3 to 5 years |
| Furniture and fixtures | 7 years |

Accelerated methods are used for income tax purposes.

### *Impairment of Long-Lived Assets*

Property and equipment, capitalized software development costs and other intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Goodwill is reviewed for impairment annually. If the sum of the expected undiscounted cash flows is less than the carrying value of the related asset or group of assets, a loss is recognized for the difference between the fair value and carrying value of the asset or group of assets.

### *Advertising Expense*

Advertising costs included in selling and marketing, are expensed when the advertising first takes place. Advertising expense was $195 thousand, $102 thousand, and $25 thousand for years 2005, 2004, and 2003, respectively.

### *Research and Development Costs*

Research and development costs are expensed in the period incurred.

### *Income Taxes*

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 the future realization of these assets.

### *Fair Value of Financial Instruments*

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

### *Stock Based Compensation*

The Company utilizes the intrinsic value method in accounting for its stock option plans. Had the Company accounted for its stock option plans based upon the fair value at the grant date for options granted under the plan, based on the provisions of SFAS 123 “Accounting for Stock-Based Compensation”, the Company's pro forma net income (loss) and pro forma net income (loss) per share would have been as follows (for purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period):

| | Years Ended September 30, | | |
|---|---|---|---|
| **(in thousands)** | **2005** | **2004** | **2003** |
| Net income (loss) as reported | $ (4,169) | $ (5,376) | $ 1,453 |
| Less stock-based compensation using fair value method | (522) | (353) | (279) |
| Less impact of discounted employee stock purchase plan using fair value method | — | (7) | (26) |
| Pro forma net income (loss) | $ (4,691) | $ (5,736) | $ 1,148 |
| **Income (loss) per share** | | | |
| Net income (loss) as reported – basic and diluted | $ (0.14) | $ (0.18) | $ 0.05 |
| Pro forma net income (loss) – basic and diluted | $ (0.15) | $ (0.19) | $ 0.04 |

Pro forma information regarding net income (loss) and net income (loss) per share has been determined as if the Company had accounted for its employee stock options under the minimum value method of SFAS No. 123 for option grants made prior to the Company's initial public offering and the Black-Scholes method for grants made subsequent to such offering. With the exception of volatility (which is ignored in the case of the minimum value method), the following weighted-average assumptions were used for all periods presented: risk-free interest rates of 1.7% to 6%, dividend yields of 0%; expected common stock market price volatility factors ranging from .50 to 1.78 and a weighted-average expected life of the option of one to five years.

***Per Share Computation***

The numerator for the calculation of basic and diluted earnings per share is net income (loss). The following table sets forth the computation of basic and diluted weighted average shares used in the earnings per share calculations:

| | Years ended September 30, | | |
|---|---|---|---|
| | **2005** | **2004** | **2003** |
| Denominator for basic earnings per share - weighted average common shares | 30,363,000 | 29,457,000 | 27,794,000 |
| Effect of dilutive options and warrants (treasury method) | — | — | 581,000 |
| Denominator for diluted earnings per share - adjusted weighted average common shares | 30,363,000 | 29,457,000 | 28,375,000 |
| Securities outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive: | | | |
| Options and warrants | 5,816,000 | 6,342,000 | 5,748,000 |

***Recent Accounting Pronouncements***

In December 2004, the Financial Accounting Standards Board ("FASB") issued revised Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment – an Amendment of FASB Statement Nos. 123 and 95". SFAS 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services or incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments, focusing primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires public entities to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions) and recognize the cost over the period during which an employee is required to provide service in exchange for the award. The Company is required to adopt SFAS No. 123(R) in fiscal 2006 beginning October 1, 2005. The Company is evaluating the impact of SFAS No. 123(R) and expects that it will record substantial non-cash compensation expenses. The adoption of SFAS No. 123(R) is not expected to have a significant effect on the Company's financial condition or cash flows but is expected to have a significant adverse effect on the reporting of its results of operations.

In November 2004, the FASB issued SFAS Statement No. 151, "Inventory Costs – an amendment of ARB No. 43" ("SFAS 151"), which is the result of its efforts to converge U.S. accounting standards for inventories with International Accounting Standards. SFAS No. 151 requires idle facility expenses, freight, handling costs, and wasted material (spoilage) costs to be recognized as current-period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We are evaluating the impact of this standard on our financial statements. The Company does not expect that the adoption of SFAS 151 will have an impact on the company's financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Non-monetary Assets, an amendment of APB Opinion No. 29. SFAS 153 replaces the exception from fair value measurement in APB Opinion No. 29 for non-monetary exchanges of similar productive assets with a general exception from fair value measurement for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is to be applied prospectively, and is effective for non-monetary asset exchanges occurring in fiscal periods after the date of issuance of SFAS 153. We do not believe the impact of adoption of SFAS 153 will be significant to our overall results of operations or financial position.

## 2. Discontinued Operations

*Media Services*

The Company completed the sale of assets utilized in the Media Services business on May 16, 2003 with Deluxe Media Services ("Deluxe"). The transaction included all assets utilized in the Company's Media Services business primarily affecting business conducted from and employees in the Company's Santa Monica California and Toronto Canada facilities. Under terms of the agreement, Deluxe acquired the Media Services business for approximately $5.6 million including cash of $4.5 million plus an estimate of $1.1 million for net working capital and assumption of certain capital leases. The Company received $5.2 million at close with the remainder due upon the final determination of actual working capital. The Company received $350 thousand of the remainder in September 2003 and received a final payment of $241 thousand in January 2004. The Company recorded a gain on sale of discontinued operations of $185 thousand in 2004 to reflect the amount that the January 2004 payment and other settlements exceeded the working capital estimates. Overall, the Company recorded a loss on disposition of the Media Services business of $1.8 million.

The 2003 loss from operations of discontinued operations includes a $1.8 million loss related to the Media Services business, on revenues of $4.9 million.

*Desktop Software*

The Company entered into an amended and restated asset purchase agreement with SP Acquisition Company, a subsidiary of Sony Pictures Digital, dated June 6, 2003 and effective May 2, 2003, to sell the assets of the Company's Desktop Software business for $19 million cash and assumption of certain trade payables, accrued liabilities and capital leases associated with the Desktop Software business. The transaction was completed on July 30, 2003. The negotiated price of the transaction contemplated net working capital balances at March 31, 2003 with any difference between the values at March 31, 2003 and the date of close to be reflected as a post closing adjustment. The Company's net working capital decreased during the period preceding close due to improved collections of customer accounts, leading to an adjustment in the purchase price of $497 thousand which was paid to Sony Pictures Digital in December 2003. The Company recorded a gain on the disposal of the Desktop Software business in fiscal 2003 of $13.9 million and recorded a $53 thousand loss in 2004 to account for the final settlement of working capital.

The 2003 loss from operations of discontinued operations includes a $1.1 million loss related to the Desktop Software business, on revenues of $12.0 million.

## 3. Commitments

The Company leases certain equipment under a capital lease agreement expiring October 2008. Lease payments, including principal and interest, will be approximately $16 thousand annually for the next three years. The Company had no capital leases at September 30, 2004.

The Company leases certain facilities and equipment under operating lease agreements expiring at various times through September 30, 2008. Total rent expense related to continuing operations on all operating leases was approximately $289, $170, and $533 thousand for the years ended September 30, 2005, 2004, and 2003, respectively.

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. The Company has an obligation to purchase a remaining $1.5 million over the next two fiscal quarters, which is not recorded on the Company's Balance Sheet. There were no obligations under such commitments as of September 30, 2004.

The Company engaged a manufacturer to build a replacement component for its Mediasite product according to designs proprietary to the Company. The Company had a commitment of approximately $164 thousand to the manufacturer at September 30, 2005 and expects the project to be completed in late fiscal 2006.

The following is a schedule by year of future minimum lease payments under operating leases:

| Fiscal Year (in thousands) | Operating |
|---|---|
| 2006 | $ 216 |
| 2007 | 222 |
| 2008 | 229 |
| 2009 | 1 |
| 2010 | — |
| Thereafter | — |
| Total | $ 668 |

## 4. Common Stock Warrants

The Company has issued restricted common stock purchase warrants to various consultants, underwriters, and debtors. Each warrant represents the right to purchase one share of common stock. All warrants are currently exercisable. The weighted average fair value of warrants granted in 2005 was $1.73.

| Exercise Prices | Warrants Outstanding at September 30, 2005 | Expiration Date |
|---|---|---|
| $ 0.48 to 0.52 | 382,450 | 2006 to 2008 |
| 1.01 to 1.91 | 387,500 | 2006 to 2010 |
| 2.20 to 2.94 | 449,309 | 2006 to 2009 |
| 11.23 | 8,900 | 2010 |
| | 1,228,159 | |

## 5. Stock Options and Employee Stock Purchase Plan

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. Each non-employee director, who is re-elected or who is continuing as a member of the board of directors on the annual meeting date and on each subsequent meeting of stockholders, is 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 market price 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.

The number of shares available for grant under these plans at September 30 is as follows:

| | Employee Stock Option Plan | Non-Qualified Stock Option Plan | Director Stock Option Plan |
|---|---|---|---|
| Shares available for grant at September 30, 2002 | 206,120 | 278,779 | 300,000 |
| Options granted | (414,000) | (430,000) | (60,000) |
| Options forfeited | 560,967 | 643,257 | – |
| Shares available for grant at September 30, 2003 | 353,087 | 492,036 | 240,000 |
| Amendment to increase shares available in plan | 3,000,000 | – | 300,000 |
| Options granted | (185,000) | – | (140,000) |
| Options forfeited | 315,225 | 153,665 | – |
| Shares available for grant at September 30, 2004 | 3,483,312 | 645,701 | 400,000 |
| Options granted | (893,000) | (96,000) | (100,000) |
| Options forfeited | 278,336 | 53,774 | – |
| Shares available for grant at September 30, 2005 | 2,868,648 | 603,475 | 300,000 |

The following table summarizes information with respect to outstanding stock options.

| | Years Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2005 | | 2004 | | 2003 | |
| | Options | Weighted Average Exercise Price | Options | Weighted Average Exercise Price | Options | Weighted Average Exercise Price |
| Outstanding at beginning of year | 4,125,953 | $ 2.34 | 5,070,078 | $ 2.37 | 6,137,234 | $ 2.45 |
| Granted | 1,089,000 | 1.39 | 325,000 | 1.69 | 904,000 | 0.55 |
| Exercised | (295,079) | 1.39 | (800,235) | 1.18 | (766,932) | 1.13 |
| Forfeited | (332,110) | 12.96 | (468,890) | 4.20 | (1,204,224) | 2.21 |
| Outstanding at end of year | 4,587,764 | $ 2.28 | 4,125,953 | $ 2.34 | 5,070,078 | $ 2.37 |
| Exercisable at end of year | 3,581,417 | | 3,273,436 | | 4,025,033 | |
| Weighted average fair value of options granted during the year | $ 0.97 | | $ 1.62 | | $ 0.44 | |

The options outstanding at September 30, 2005 have been segregated into five ranges for additional disclosure as follows:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Exercise Prices | Options Outstanding at September 30,2005 | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Options Exercisable at September 30, 2005 | Weighted Average Exercise Price |
| $0.42 to $0.74 | 484,935 | 7.24 | $ 0.44 | 358,261 | $ 0.45 |
| $1.01 to $1.94 | 3,456,905 | 7.00 | 1.22 | 2,607,233 | 1.16 |
| $2.00 to $2.50 | 372,233 | 4.68 | 2.28 | 342,232 | 2.29 |
| $3.13 to $6.61 | 193,191 | 3.65 | 4.57 | 193,191 | 4.57 |
| $15.50 to $59.88 | 80,500 | 4.47 | 53.76 | 80,500 | 53.76 |

The Company maintained an Employee Stock Purchase Plan (Stock Purchase Plan), which allowed for the issuance of 1.0 million shares of common stock. There were 16 and 150 thousand shares issued under the plan for the years ended September 30, 2004 and 2003, respectively. All employees of the Company who had completed three months of employment were eligible to participate in the Stock Purchase Plan, provided the employee would not hold 5% or more of the total combined voting power of the Company. Shares were purchased at the end of a specified period at the lower of 85% of the market value at the beginning or the end of the specified period through accumulation of payroll deductions. The Stock Purchase Plan was terminated on June 30, 2004.

## 6. Income Taxes

Income tax expense (benefit) consists of the following (in thousands):

| | Years Ended September 30, | | |
|---|---|---|---|
| | 2005 | 2004 | 2003 |
| Federal income tax | $ — | $ — | $ — |
| Canadian income tax (benefit) | — | — | (68) |
| Deferred income tax expense (benefit) | (1,515) | (2,489) | 1,135 |
| Change in valuation allowance | 1,515 | 2,489 | (1,135) |
| Income tax expense (benefit) | $ — | $ — | $ (68) |

The reconciliation of income tax expense (benefit) computed at the U.S. federal statutory rate to income tax expense (benefit) is as follows (in thousands):

| | Years Ended September 30, | | |
|---|---|---|---|
| | 2005 | 2004 | 2003 |
| Income tax expense (benefit) at U.S. statutory rate of 34% | $ (1,417) | $ (1,828) | $ 494 |
| Permanent differences, net | (34) | (145) | (99) |
| Adjustment of temporary differences to income tax returns | (64) | (516) | 554 |
| Other | — | — | 186 |
| Canadian income tax benefit | — | — | (68) |
| Change in valuation allowance | 1,515 | 2,489 | (1,135) |
| Income tax benefit | $ — | $ — | $ (68) |

The significant components of the deferred tax accounts recognized for financial reporting purposes are as follows (in thousands):

| | September 30, | |
|---|---|---|
| | 2005 | 2004 |
| Deferred tax assets: | | |
| Net operating loss and other carryforwards | $ 26,967 | $ 25,409 |
| Common stock warrants | 925 | 818 |
| Allowance for doubtful accounts | 45 | 31 |
| Other | 9 | 8 |
| Total deferred tax assets | 27,946 | 26,266 |
| Valuation allowance | (27,351) | (25,836) |
| Deferred tax liability-depreciation of property and equipment | (23) | (64) |
| Deferred tax liability-amortization of goodwill, other intangible assets and capitalized software development costs | (572) | (366) |
| Net deferred tax liabilities | $ — | $ — |

At September 30, 2005, the Company had net operating loss carry forwards of approximately $68 million for U.S. Federal and state tax purposes, which expire in varying amounts between 2013 and 2025.

The Company's net deferred tax asset has been offset by a valuation allowance of the same amount. The valuation allowance has been recorded due to the uncertainty of realization of the deferred tax asset.

### 7. Savings Plan

The Company's defined contribution 401(k) savings plan covers substantially all employees meeting certain minimum eligibility requirements. Participating employees can elect to defer a portion of their compensation and contribute it to the plan on a pretax basis. The Company may also match certain amounts and/or provide additional discretionary contributions, as defined. The Company made discretionary contributions of $139, $83, and $207 thousand during the years ended September 30, 2005, 2004 and 2003, respectively.

### 8. Related-Party Transactions

The Company incurred fees of $109, $183, and $427 thousand during the years ended September 30, 2005, 2004 and 2003, respectively, to a law firm whose partner is a director and stockholder of the Company.

The Company recorded Mediasite product and customer support revenue related to $663 and $300 thousand of billings during the years ended September 30, 2005 and 2004 to Mediasite KK, a Japanese reseller in which the Company has an equity interest. Mediasite KK owed the Company $187 and $189 thousand on such billings at September 30, 2005 and 2004, respectively.

During the years ended September 30, 2005, 2004 and 2003, the Company had a loan outstanding to an executive totaling $26. The loan is backed by company stock.

In November 2002, the Company completed a bridge financing transaction of $1.0 million with the brother of Rimas Buinevicius, Chief Executive Officer. Mr. Buinevicius abstained from board of director discussion regarding approval of the transaction. The note was backed by substantially all assets of the Company and was due, along with $250 thousand of interest, at the earlier of March 2003 or upon completion of a transaction generating sufficient cash to allow for payment. The note was repaid in July 2003, with the proceeds from the sale of the Desktop Software business.

### 9. Goodwill and Other Intangible Assets

The Company accounts for goodwill and their intangible assets in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets". SFAS No. 142 requires that goodwill and intangible assets that have indefinite useful lives not be amortized but, instead, tested at least annually for impairment. We assess the impairment of goodwill and capitalized software development costs on an annual basis or whenever events or changes in circumstances indicate that the fair value of these assets is less than the carrying value. 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.

The Company tested goodwill recognized in connection with the acquisition of Mediasite at July 1, 2005 and determined it was not impaired. Subsequent impairment charges for Mediasite or other acquisitions, if any, will be reflected as an operating expense in the statement of operations.

The following tables present details of the Company's total intangible assets at September 30, 2005 and 2004:

| (in thousands) | Life (years) | Gross | Accumulated Amortization at September 30, 2004 | Balance at September 30, 2004 | Accumulated Amortization at September 30, 2005 | Balance at September 30, 2005 |
|---|---|---|---|---|---|---|
| Amortizable: | | | | | | |
| License agreement | 5 | $ 120 | $ 72 | $ 48 | $ 96 | $ 24 |
| Trade name | 5 | 130 | 78 | 52 | 104 | 26 |
| | | 250 | 150 | 100 | 200 | 50 |
| Non-amortizable goodwill | | 7,576 | - | 7,576 | - | 7,576 |
| Total | | $ 7,826 | $ 150 | $ 7,676 | $ 200 | $ 7,626 |

**10. Quarterly Financial Data (unaudited)**

The following table sets forth selected quarterly financial and stock price information for the years ended September 30, 2005 and 2004. The operating results are not necessarily indicative of results for any future period.

| (in thousands except per share data) | Quarterly Financial Data | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Q4-'05 | Q3-'05 | Q2-'05 | Q1-'05 | Q4-'04 | Q3-'04 | Q2-'04 | Q1-'04 |
| Revenues | $ 2,510 | $ 2,175 | $ 2,066 | $ 1,591 | $ 1,419 | $ 1,154 | $ 941 | $ 899 |
| Gross margin | 1,737 | 1,399 | 1,397 | 1,055 | 858 | 711 | 510 | 575 |
| Loss from continuing operations | (820) | (1,124) | (966) | (1,446) | (1,437) | (1,623) | (1,325) | (1,222) |
| Net loss | (763) | (1,065) | (941) | (1,400) | (1,419) | (1,598) | (1,291) | (1,068) |
| Basic and diluted net loss per share | $ (0.02) | $ (0.03) | $ (0.03) | $ (0.05) | $ (0.05) | $ (0.05) | $ (0.04) | $ (0.04) |

## ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

## ITEM 9A. CONTROLS AND PROCEDURES

**Disclosure Controls and Procedures**

Based on evaluations as of the end of the period covered by this report, 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) were effective.

### Changes in Internal Control Over Financial Reporting

During the period covered by this report, we have not made any change to our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## ITEM 9B. OTHER INFORMATION

None.

# PART III

## ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by Item 10 of Form 10-K with respect to directors and executive officers is incorporated herein by reference to the information contained in the section entitled "Proposal One: Election of Directors" and "Executive Officers of Sonic", respectively, in the Company's definitive Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Company's 2005 Annual Meeting of Stockholders, which will be filed no later than January 28, 2006 (the "Proxy Statement").

Item 405 of Regulation S-K calls for disclosure of any known late filings or failure by an insider to file a report required by Section 16(a) of the Securities Act. This information is contained in the Section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement and is incorporated herein by reference.

Item 401 of Regulation S-K calls for disclosure of whether or not the Company has a financial expert serving on the audit committee of its Board of Directors, and if so who that individual is. This information is contained in the Section entitled "Meetings and Committees of Directors" in the Proxy Statement and is incorporated herein by reference.

Sonic Foundry has adopted a code of ethics that applies to all officers and employees, including Sonic Foundry's principal executive officer, its principal financial officer, and persons performing similar functions. This code of ethics is available, without charge, to any investor who requests it. Request should be addressed in writing to Mr. Kenneth A. Minor, Corporate Secretary, 222 West Washington Avenue, Suite 775, Madison, Wisconsin 53703.

## ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 of Form 10-K is incorporated herein by reference to the information contained in the sections entitled "Directors Compensation", "Executive Compensation and Related Information" and "Compensation Committee Interlocks and Insider Participation" in the Proxy Statement.

## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 of Form 10-K is incorporated herein by reference to the information contained in the sections entitled "Security Ownership of Certain Beneficial Owners and Management" in the Proxy Statement.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by Item 13 of Form 10-K is incorporated herein by reference to the information contained in the section entitled "Certain Transactions" in the Proxy Statement.

## ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by Item 14 of Form 10-K is incorporated herein by reference to the information contained in the section entitled "Ratification of Appointment of Independent Auditors – Fiscal 2004 and 2005 Audit Fee Summary" in the Proxy Statement.

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# Our technology at work.

Thousands of hours of information are captured every day with Sonic Foundry's technology. Mediasite.com provides a glimpse into this world by linking all the public presentations available on the Internet from the wide variety of organizations that are mediasiting their knowledge. Explore the world of Mediasite at www.mediasite.com.