SONIC FOUNDRY INC
Form 10-Q
February 09, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly period ended December 31, 2016
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 000-30407

SONIC FOUNDRY, INC.
(Exact name of registrant as specified in its charter)

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

222 West Washington Ave, Madison, WI 53703
(Address of principal executive offices)

(608) 443-1600
(Registrant’s telephone number including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days
Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (see definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act).
Large accelerated filer ¨ Accelerated filer ¨

Non-accelerated filer ¨ Smaller reporting company x
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No x
State the number of shares outstanding of each of the issuer’s common equity as of the last practicable date:
Class Outstanding

	February 3, 2017
Common Stock, $0.01 par value	4,416,423

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PART I. FINANCIAL INFORMATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. For a more complete discussion of accounting policies and certain other information, refer to the Company's annual report filed on Form 10-K for the fiscal year ended September 30, 2016.

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Item 1
Sonic Foundry, Inc.
Condensed Consolidated Balance Sheets
(in thousands, except for share data)
(Unaudited)

	December 31, 2016	September 30, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 1,080	$ 1,794
Accounts receivable, net of allowances of $195 and $225	10,324	11,646
Inventories	1,271	1,904
Prepaid expenses and other current assets	1,148	1,404
Total current assets	13,823	16,748
Property and equipment:		
Leasehold improvements	1,032	879
Computer equipment	6,040	5,837
Furniture and fixtures	888	825
Total property and equipment	7,960	7,541
Less accumulated depreciation and amortization	5,859	5,510
Property and equipment, net	2,101	2,031
Other assets:		
Goodwill	10,862	11,310
Customer relationships, net of amortization of $790 and $723	1,596	1,882
Product rights, net of amortization of $318 and $287	354	385
Other intangibles, net of amortization of $254 and $236	57	76
Other long-term assets	615	726
Total assets	$ 29,408	$ 33,158
Liabilities and stockholders' equity		
Current liabilities:		
Revolving line of credit	$ 3,042	$ 1,772
Accounts payable	906	961
Accrued liabilities	1,613	1,883
Unearned revenue	10,618	12,834
Current portion of capital lease and financing arrangements	272	283
Current portion of notes payable, net of discounts	1,567	1,567
Current portion of subordinated note payable	—	93
Total current liabilities	18,018	19,393
Long-term portion of unearned revenue	1,530	1,257
Long-term portion of capital lease and financing arrangements	207	231
Long-term portion of notes payable and warrant debt, net of discounts	484	871
Derivative liability, at fair value	46	67
Other liabilities	274	259
Deferred tax liability	4,461	4,564
Total liabilities	25,020	26,642
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $.01 par value, authorized 500,000 shares; none issued	—	—
	—	—

5% Preferred stock, Series B, voting, cumulative, convertible, $.01 par value (liquidation preference at par), authorized 1,000,000 shares, none issued		
Common stock, $.01 par value, authorized 10,000,000 shares; 4,424,275 shares issued and 4,411,559 shares outstanding, respectively	44	44
Additional paid-in capital	197,318	197,064
Accumulated deficit	(191,723)	(190,214)
Accumulated other comprehensive loss	(1,056)	(183)
Receivable for common stock issued	(26)	(26)
Treasury stock, at cost, 12,716 shares	(169)	(169)
Total stockholders' equity	4,388	6,516
Total liabilities and stockholders' equity	$ 29,408	$ 33,158

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See accompanying notes to the condensed consolidated financial statements.

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

	Three Months Ended December 31,	
	2016	2015
Revenue:		
Product	$3,681	$3,791
Services	5,538	5,199
Other	88	101
Total revenue	9,307	9,091
Cost of revenue:		
Product	1,687	1,865
Services	911	846
Total cost of revenue	2,598	2,711
Gross margin	6,709	6,380
Operating expenses:		
Selling and marketing	4,810	4,412
General and administrative	1,450	1,471
Product development	1,951	1,614
Total operating expenses	8,211	7,497
Loss from operations	(1,502)	(1,117)
Non-operating income (expenses):		
Interest expense, net	(150)	(149)
Other income, net	12	65
Total non-operating expenses	(138)	(84)
Loss before income taxes	(1,640)	(1,201)
Benefit (provision) for income taxes	131	(6)
Net loss	$(1,509)	$(1,207)
Loss per common share:		
– basic	$(0.34)	$(0.28)
– diluted	$(0.34)	$(0.28)
Weighted average common shares		
– basic	4,411,559	4,363,740
– diluted	4,411,559	4,363,740

See accompanying notes to the condensed consolidated financial statements

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Sonic Foundry, Inc.
Condensed Consolidated Statements of Comprehensive Loss
(in thousands)
(Unaudited)

	Three Months Ended December 31,	
	2016	2015
Net loss	$(1,509)	$(1,207)
Foreign currency translation adjustment	(873)	(54)
Comprehensive loss	$(2,382)	$(1,261)

See accompanying notes to the condensed consolidated financial statements

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

	Three Months Ended December 31,	
	2016	2015
Operating activities		
Net loss	$(1,509)	$(1,207)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Amortization of other intangibles	140	179
Depreciation and amortization of property and equipment	362	394
Provision for doubtful accounts	(30)	(50)
Deferred taxes	(3)	6
Stock-based compensation expense related to stock options	254	334
Remeasurement gain on subordinated debt	(6)	(6)
Remeasurement gain on derivative liability	(21)	(62)
Changes in operating assets and liabilities:		
Accounts receivable	1,077	3,426
Inventories	614	(152)
Prepaid expenses and other current assets	147	61
Accounts payable and accrued liabilities	(147)	(1,492)
Other long-term liabilities	87	(22)
Unearned revenue	(1,793)	(510)
Net cash provided by (used in) operating activities	(828)	899
Investing activities		
Purchases of property and equipment	(548)	(77)
Net cash used in investing activities	(548)	(77)
Financing activities		
Proceeds from notes payable	—	500
Proceeds from line of credit	6,922	2,300
Payments on notes payable	(497)	(447)
Payments on line of credit	(5,585)	(2,400)
Payment of debt issuance costs	—	(10)
Payments on capital lease and financing arrangements	(73)	(65)
Net cash provided by (used in) financing activities	767	(122)
Changes in cash and cash equivalents due to changes in foreign currency	(105)	(10)
Net increase (decrease) in cash and cash equivalents	(714)	690
Cash and cash equivalents at beginning of period	1,794	1,976
Cash and cash equivalents at end of period	$1,080	$2,666
Supplemental cash flow information:		
Interest paid	$139	$165
Income taxes paid, foreign	27	10
Non-cash financing and investing activities:		
Property and equipment financed by capital lease or accounts payable	34	207
Debt discount	—	38

See accompanying notes to the condensed consolidated financial statements.

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Sonic Foundry, Inc.
Notes to Condensed Consolidated Financial Statements
December 31, 2016
(Unaudited)

1. Basis of Presentation and Significant Accounting Policies

Financial Statements

In the opinion of management, the accompanying unaudited consolidated condensed financial statements contain all adjustments necessary to present fairly the Company's financial position, results of operations and cash flows for the periods presented. All such adjustments are of a normal recurring nature. Operating results for the three month period ended December 31, 2016 are not necessarily indicative of the results that might be expected for the year ending September 30, 2017.

Inventory Valuation

Inventory consists of raw materials and supplies used in the assembly of Mediasite recorders and finished units. Inventory of completed 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):

	December 31, 2016	September 30, 2016
Raw materials and supplies	$ 154	$ 149
Finished goods	1,117	1,755
	$ 1,271	$ 1,904

Capitalized Software Development Costs

Software development costs incurred in conjunction with product development are charged to research and development expense until technological feasibility is established. Thereafter, until the product is released for sale, software development costs are capitalized and reported at the net realizable value of the related product. Typically the period between achieving technological feasibility of the Company's products and the general availability of the products has been short. Consequently, software development costs qualifying for capitalization are typically immaterial and are generally expensed to research and development costs, as incurred. Upon product release, the amortization of software development costs is determined annually as the greater of the amount computed using the ratio of current gross revenues for the products to their total of current and anticipated future gross revenues, or the straight-line method over the estimated economic life of the products, expected to be three years. Amortization expense of software development costs of $45 thousand is included in Cost of Revenue – Product for the three months ended December 31, 2015. The gross amount of capitalized external and internal development costs was $533 thousand at December 31, 2016 and September 30, 2016 and was fully amortized during the fiscal year ended September 30, 2016. There were no software development efforts that qualified for capitalization for the three months ended December 31, 2016 or 2015, respectively.

Fair Value of Financial Instruments

Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis

The Company's goodwill, intangible assets and other long-lived assets are nonfinancial assets that were acquired either as part of a business combination, individually or with a group of other assets. These nonfinancial assets were initially measured and recognized at amounts equal to the fair value determined as of the date of acquisition. Fair value measurements of reporting units are estimated using an income approach involving discounted or undiscounted cash flow models and the public company guideline method that contain certain Level 3 inputs requiring management judgment, including projections of economic conditions and customer demand, revenue and margins, changes in competition, operating costs, working capital requirements, and new product introductions. Fair value measurements of the reporting units associated with the Company’s goodwill balances are estimated at least annually at the beginning of the fourth quarter of each fiscal year for purposes of impairment testing. Fair value measurements associated with the Company’s intangible assets and other long-lived assets are estimated when events or changes in circumstances such as market value, asset utilization, physical change, legal factors, or other matters indicate that the carrying value may not be recoverable.

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In determining the fair value of financial assets and liabilities, the Company currently utilizes market data or other assumptions that it believes market participants would use in pricing the asset or liability in the principal or most advantageous market, and adjusts for non-performance and/or other risk associated with the Company as well as counterparties, as appropriate. When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

Level 1 Inputs: Unadjusted quoted prices which are available in active markets for identical assets or liabilities accessible to the Company at the measurement date.

Level 2 Inputs: Inputs other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at measurement date.

The hierarchy gives the highest priority to Level 1, as this level provides the most reliable measure of fair value, while giving the lowest priority to Level 3.

Financial Liabilities Measured at Fair Value on Recurring Basis

The initial fair values of PFG debt and warrant debt (see Note 4) were based on the present value of expected future cash flows and assumptions about current interest rates and the creditworthiness of the Company (Level 3). The fair value of the bifurcated conversion feature represented by the warrant derivative liability which is measured at fair value on a recurring basis is based on a Black Scholes option pricing model with assumptions for stock price, exercise price, volatility, expected term, risk free interest rate and dividend yield similar to those described for share-based compensation which were generally observable (Level 2).

Financial liabilities measured at fair value on a reoccurring basis are summarized below (in thousands):

December 31, 2016	Level 1	Level 2	Level 3	Total Fair Value
Derivative liability	—	46	—	46
	$ —	$ 46	$ —	$ 46

September 30, 2016	Level 1	Level 2	Level 3	Total Fair Value
Derivative liability	—	67	—	67
	$ —	$ 67	$ —	$ 67

Included below is a summary of the changes in our Level 3 fair value measurements (in thousands):

	PFG Debt, net of discount	Warrant Debt
Balance at September 30, 2016	$ 1,225	$ 102
Activity during the current period:		
Payments to PFG	(202)	—

Change in fair value	18	5
Balance at December 31, 2016	$ 1,041	$ 107

Financial Instruments Not Measured at Fair Value

The Company's other financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable and debt instruments, excluding the PFG debt. The book values of cash and cash equivalents, accounts receivable, debt

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(excluding the PFG debt) and accounts payable are considered to be representative of their respective fair values. The carrying value of capital lease obligations and debt (excluding the PFG debt), including the current portion, approximates fair market value as the variable and fixed rate approximates the current market rate of interest available to the Company.

Legal Contingencies

When legal proceedings are brought or claims are made against the Company and the outcome is uncertain, we are required to determine whether it is probable that an asset has been impaired or a liability has been incurred. If such impairment or liability is probable and the amount of loss can be reasonably estimated, the loss must be charged to earnings.

When it is considered probable that a loss has been incurred, but the amount of loss cannot be estimated, disclosure but not accrual of the probable loss is required. Disclosure of a loss contingency is also required when it is reasonably possible, but not probable, that a loss has been incurred and there is a possibility the loss could be material.

No legal contingencies were recorded or were required to be disclosed for the three months ended December 31, 2016 and 2015, respectively.

Stock Based Compensation

The Company uses a lattice valuation model to account for all employee stock options granted. The lattice valuation model is a more flexible analysis to value options because of its ability to incorporate inputs that change over time, such as actual exercise behavior of option holders. The Company uses historical data to estimate the option exercise and employee departure behavior in the lattice valuation model. Expected volatility is based on historical volatility of the Company’s stock. The Company considers all employees to have similar exercise behavior and therefore has not identified separate homogeneous groups for valuation. The expected term of options granted is derived from the output of the option pricing model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods the options are expected to be outstanding is based on the U.S. Treasury yields in effect at the time of grant. Forfeitures are based on actual behavior patterns.

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

	Three Months Ended December 31,	
	2016	2015
Expected life	4.9 years	4.9 years
Risk-free interest rate	1.08%	1.23%
Expected volatility	56.98%	53.75%
Expected forfeiture rate	10.22%	11.76%
Expected exercise factor	1.35	1.43
Expected dividend yield	0%	0%

A summary of option activity at December 31, 2016 and changes during the three months then ended is presented below:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Period in Years
Outstanding at October 1, 2016	1,602,822	$ 9.51	6.6
Granted	300,270	4.75	9.8
Exercised	—	—	0
Forfeited	(12,124)	30.67	1.9

Outstanding at December 31, 2016	1,890,968	8.62	6.7
Exercisable at December 31, 2016	1,283,111	9.62	5.6

A summary of the status of the Company's non-vested shares and changes during the three month period ended December 31, 2016 is presented below:

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	2016	
Non-vested Shares	Shares	Weighted-Average Grant Date Fair Value
Non-vested at October 1, 2016	539,985	$ 3.21
Granted	300,270	3.14
Vested	(230,562)	1.83
Forfeited	(1,836)	3.15
Non-vested at December 31, 2016	607,857	$ 2.52

The weighted average grant date fair value of options granted during the three months ended December 31, 2016 was $3.14. As of December 31, 2016, there was $991 thousand of total unrecognized compensation cost related to non-vested stock-based compensation, with total forfeiture adjusted unrecognized compensation cost of $803 thousand. The cost is expected to be recognized over a weighted-average remaining life of 1.8 years.

Stock-based compensation recorded in the three months ended December 31, 2016 was $251 thousand. Stock-based compensation recorded in the three months ended December 31, 2015 was $334 thousand. There was no cash received from exercises under all stock option plans and warrants in either of the three months ended December 31, 2016 or 2015. There were no tax benefits realized for tax deductions from option exercises in either of the three months ended December 31, 2016 or 2015, respectively. The Company currently expects to satisfy share-based awards with registered shares available to be issued.

The Company also has an Employee Stock Purchase Plan (Purchase Plan) under which an aggregate of 150,000 common shares may be issued. A total of 18,844 shares are available to be issued under the plan. The Company recorded stock compensation expense under this plan of $3 thousand and $7 thousand during each of the three months ended December 31, 2016 and 2015, respectively.

Per share computation

Basic loss per share has been computed using the weighted-average number of shares of common stock outstanding during the period, less shares that may be repurchased, and excludes any dilutive effects of options and warrants. In periods where the Company reports net income, diluted net income per share is computed using common equivalent shares related to outstanding options and warrants to purchase common stock. The numerator for the calculation of basic and diluted earnings per share is net loss. The following table sets forth the computation of basic and diluted weighted average shares used in the earnings per share calculations:

	Three Months Ended December 31,	
	2016	2015
Denominator for basic loss per share - weighted average common shares	4,411,559	4,363,740
Effect of dilutive options (treasury method)	—	—
Denominator for diluted loss per share - adjusted weighted average common shares	4,411,559	4,363,740
Options and warrants outstanding during each period, but not included in the computation of diluted loss per share because they are antidilutive	2,025,770	1,773,057

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2014-09, “Revenue from Contracts with Customers (Topic 606)”. The guidance substantially converges final standards on revenue recognition between the FASB and the International Accounting Standards Board providing a framework on addressing revenue recognition issues and, upon its effective date, replaces almost all existing revenue recognition guidance, including industry-specific guidance, in current U.S. generally accepted accounting principles. The FASB subsequently issued a one-year deferral of the effective date for the new revenue reporting standard for entities reporting under U.S. GAAP. In accordance with the deferral, the guidance is effective for annual reporting periods beginning after December 15, 2017. Subsequently, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations" ("ASU 2016-08"); ASU 2016-10, "Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing" ("ASU 2016-10"); ASU 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow-Scope

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Improvements and Practical Expedients" ("ASU 2016-12"); and ASU 2016-20 "Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers ("ASU 2016-20"). The Company must adopt ASU 2016-08, ASU 2016-10 and ASU 2016-12 with ASU 2014-09. The Company is currently evaluating the timing of adopting and the related impact, if any, it may have on the consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, "Inventory (Topic 330)" ("ASU 2015-11"). The amendments in ASU 2015-11 require an entity to measure inventory at the lower of cost and net realizable value. The amendments in ASU 2015-11 are effective for fiscal years beginning after December 15, 2016 and interim periods within those years. Early adoption is permitted. The amendments should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The Company does not believe the implementation of this standard will result in a material impact to its consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, "Income Taxes (Topic 740)", ("ASU 2015-17"). ASU 2015-17 simplifies the presentation of deferred income taxes. The amendments in ASU 2015-17 are effective for financial statements issued for annual periods beginning after December 15, 2016, including interims periods within those annual periods. The amendments may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company does not believe the implementation of this standard will result in a material impact to its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10)", ("ASU 2016-01"). ASU 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments in ASU 2016-01 are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values should be applied prospectively to equity investments that exist at the date of the adoption. The Company is currently evaluating this guidance and its impact to the consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)", ("ASU 2016-02"). ASU 2016-02 aims to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for public entities. Early application of the amendment is permitted. The Company is currently reviewing this guidance and its impact to the consolidated financial statements.

In March 2016, the FASB issued ASU 2016-05, "Derivatives and Hedging (Topic 815)", ("ASU 2016-05"). ASU 2016-05 clarifies the effect of novation related to a derivative instrument. The amendments in ASU 2016-05 are effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. An entity has the option to apply the amendments in ASU 2016-05 on either a prospective or a modified retrospective basis. The Company is currently evaluating this guidance and its impact to the consolidated financial statements.

In March 2016, the FASB issued ASU 2016-06, "Derivatives and Hedging (Topic 815)", ("ASU 2016-06"). ASU 2016-06 clarify the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. The amendments in ASU 2016-06 are effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Entities should apply the amendments on a modified retrospective basis to existing debt instruments as of the beginning of the fiscal year for which the amendments are effective. The Company is currently evaluating this guidance and its impact to the consolidated financial statements.

In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606)", ("ASU 2016-08"). The amendments in 2016-08 do not change the core principles of the previous guidance, but rather clarify the implementation guidance on principal versus agent considerations. The effective date and transition requirements for the amendments in ASU 2016-08 are the same as the effective date and transition requirements of ASU 2014-09. The Company will evaluate this guidance concurrent with ASU 2014-09.

In March 2016, the FASB issued ASU 2016-09, "Compensation-Stock Compensation (Topic 718)", ("ASU 2016-09"). ASU 2016-09 simplifies the accounting for share-based payment transactions. The amendments in ASU

2016-09 are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is currently evaluating this guidance and its impact to the consolidated financial statements.

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In May 2016, the FASB issued ASU 2016-11, "Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815)", ("ASU 2016-11"). ASU 2016-11 rescinds SEC paragraphs pursuant to the SEC Staff Announcement, "Rescission of Certain SEC Staff Observer Comments upon Adoption of Topic 606", and the SEC Staff Announcement, "Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or Equity", announced at the March 3, 2016 Emerging Issues Task Force (EITF) meeting. The effective dates in ASU 2016-11 coincide with the effective dates of Topic 606 (ASU 2014-09) and ASU 2014-16. The Company is currently evaluating the impact of adopting ASU 2014-09 and related amendments, such as ASU 2016-11, to determine the impact, if any, it may have on the consolidated financial statements. The Company previously reviewed ASU 2014-16 and determined that is it not applicable.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230)", ("ASU 2016-15"). ASU 2016-15 addresses classification of certain cash receipts and cash payments within the statement of cash flows. The amendments are effective for fiscal years beginning after December 15, 2017, and interim periods with those fiscal years. The Company is currently evaluating this guidance and its impact to the consolidated financial statements.

In October 2016, the FASB issued ASU 2016-16, "Income Taxes (Topic 740)", ("ASU 2016-16"). ASU 2016-16 prohibits the recognition of current and deferred income taxes for an intra-entity transfer until the asset has been sold to an outside party. The amendment in ASU 2016-16 are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. The Company is currently evaluating this guidance and its impact to the consolidated financial statements.

In January 2017, the FASB issued ASU 2017-01 (ASC Topic 805), Business Combination: Clarifying the Definition of a Business. The amendments in this ASU change the definition of a business to assist with evaluating when a set of transferred assets and activities is a business. The Company is required to adopt the guidance in the first quarter of fiscal 2019. Early adoption is permitted. The Company is in the process of assessing the impact, if any, of this ASU on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment, ("ASU 2016-16"). ASU 2017-14 simplifies the subsequent measurement of goodwill by allowing an entity to perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. This update also eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. The amendment in ASU 2017-04 are effective for annual reporting periods beginning after December 15, 2019, including interim reporting periods within those annual reporting periods. The Company is currently evaluating this guidance and its impact to the consolidated financial statements.
Accounting standards that have been issued but are not yet effective by the FASB or other standards-setting bodies that do not require adoption until a future date, which are not discussed above, are not expected to have a material impact on the Company's consolidated financial statements upon adoption.

2. Related Party Transactions

During the three months ended December 31, 2016, the Company incurred fees of $31 thousand, to a law firm, a partner of which is a director and stockholder of the Company. The Company incurred similar fees of $32 thousand, during the three months ended December 31, 2015. The Company had accrued liabilities for unbilled services of $45 thousand at both December 31, 2016 and September 30, 2016, to the same law firm.
At December 31, 2016 and September 30, 2016, the Company had a loan outstanding to an executive totaling $26 thousand. The loan is collateralized by Company stock.

3. Commitments

Inventory Purchase Commitments

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. At December 31, 2016, the Company has an obligation to purchase $888 thousand of Mediasite product, which is not recorded on the Company’s Condensed Consolidated Balance Sheet.

Operating Leases

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In November 2011, the Company occupied office space related to a lease agreement entered into on June 28, 2011. The lease term is from November 2011 through December 2018. The lease includes a tenant improvement allowance of $613 thousand that was recorded as a leasehold improvement liability and is being amortized as a credit to rent expense on a straight-line basis over the lease term. At December 31, 2016 and September 30, 2016, the unamortized balance was $160 thousand and $182 thousand, respectively.

4. Credit Arrangements

Silicon Valley Bank

The Company and its wholly owned subsidiary, Sonic Foundry Media Systems, Inc. (the “Companies”) entered into the Second Amended and Restated Loan and Security Agreement with Silicon Valley Bank, dated June 27, 2011, as amended by the First, Second, Third, Fourth, Fifth, Sixth, and Seventh Amendments, dated May 31, 2013, January 10, 2014, March 31, 2014, January 27, 2015, May 13, 2015, October 5, 2015, and February 8, 2016 (the Second Amended and Restated Loan Agreement, as amended by the First, Second, Third, Fourth, Fifth, Sixth, and Seventh Amendments, collectively, the “Second Amended and Restated Loan Agreement”). The Second Amended and Restated Loan Agreement provides for a revolving line of credit in the maximum principal amount of $4,000,000. Interest accrues on the revolving line of credit at the variable per annum rate equal to the Prime Rate (as defined) plus one and one-quarter percent (1.25%), which currently equates to 5.00%. The Second Amended and Restated Loan Agreement provides for an advance rate on domestic receivables of 80%, and an advance rate on foreign receivables of 75% of the lesser of (x) Foreign Eligible Accounts (as defined) or (y) $1,000,000. The maturity date of the revolving credit facility was January 31, 2017. Under the Second Amended and Restated Loan Agreement, a term loan was entered into on January 27, 2015 in the original principal amount of $2,500,000 which accrues interest at the variable per annum rate equal to the Prime Rate (as defined) plus two and three-quarters percent (which currently equates to an interest rate of 6.50%), and is to be repaid in 36 equal monthly principal payments, beginning in February 2015. The Second Amended and Restated Loan Agreement also requires Sonic Foundry to comply with certain financial covenants, including (i) a liquidity financial covenant, which requires minimum Liquidity (as defined), tested with respect to the Company only (excluding the subsidiaries) of at least 1.50:1.00 at the last day of each month and(ii) a covenant that requires a Minimum EBITDA, as defined, on a trailing six month period, of at least $1.00 plus the net change in Deferred Revenue, as defined, with such covenant measured as of the last day of each fiscal quarter. Collections from accounts receivable are directly applied to the outstanding obligations under the revolving line of credit.

On December 9, 2016, the Companies entered into an Eighth Amendment to the Second Amended and Restated Loan and Security Agreement (the "Eighth Amendment") with Silicon Valley Bank. The Eighth Amendment: (i) extends the revolving line of credit maturity date to January 31, 2019, (ii) increases maximum subsidiary indebtedness allowable to $1,000,000 outstanding at any one time and (iii) provides for a "streamline period", during which bank reporting is due monthly when a streamline period is in effect and weekly when a streamline period is not in effect. At December 31, 2016, a balance of $903 thousand was outstanding on the term loans with Silicon Valley Bank, with an effective interest rate of six-and-one-half percent (6.50%), and a balance of $2.6 million was outstanding on the revolving line of credit, with an effective interest rate of five percent (5.00%). At September 30, 2016, a balance of $1.1 million was outstanding on the term loans with Silicon Valley Bank and a balance of $1.6 million was outstanding on the revolving line of credit. At December 31, 2016, there was a remaining amount of $1.4 million available under the line of credit facility for advances. At December 31, 2016, the Company was not in compliance with the Minimum EBITDA financial covenant in the Second Amended and Restated Loan Agreement, as amended. Silicon Valley Bank subsequently waived the covenant default.

Partners for Growth IV, L.P.

On May 13, 2015, Sonic Foundry, Inc., entered into a Loan and Security Agreement (the “Loan and Security Agreement”) with Partners for Growth IV, L.P. (“PFG”), (the “Loan and Security Agreement”).

The Loan and Security Agreement provides for a Term Loan in the amount of $2,000,000, which can be disbursed in two (2)Tranches as follows: Tranche 1 was drawn in the amount of $1,500,000 shortly after execution thereof; and Tranche 2 in the amount of $500,000, was drawn on December 15, 2015.

Each tranche of the Term Loan bears interest at 10.75% per annum. Tranche 1 of the Term Loan was payable interest only until November 30, 2015. Beginning on December 1, 2015, principal is due in 30 equal monthly principal installments, plus accrued interest, continuing until May 1, 2018, when the principal balance is to be paid in full. Tranche 2 of the Term Loan is payable in 29 equal monthly principal installments, plus accrued interest, beginning January 1, 2015 and continuing until May 1, 2018.
The principal of the Term Loan may be prepaid at any time, without a prepayment fee.

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Coincident with execution of the Loan and Security Agreement, the Company entered into a Warrant Agreement ("Warrant") with PFG. Pursuant to the terms of the Warrant, the Company issued to PFG a warrant to purchase up to 50,000 shares of common stock of the Company at an exercise price of $9.66 per share, subject to certain adjustments, of which 37,500 were exercisable with the disbursement of Tranche 1 and 12,500 became exercisable with the disbursement under Tranche 2. Pursuant to the Warrant, PFG is also entitled, under certain conditions, to require the Company to exchange the Warrant for the sum of $200,000. Each warrant issued has an exercise term of 5 years from the date of issuance. On August 12, 2015, the Company and PFG entered into a waiver agreement to waive a then existing covenant default and to change the exercise price of the aforementioned warrants from $9.66 per share to $6.80 per share.
The warrants can be settled for cash in the event of acquisition of the company, any liquidation of the company, or expiration of the warrant. The Company has determined the cash payment date to be the expiration date (May 14, 2020). Due to the fixed payment amount on the expiration date, the warrant structure is in substance a debt arrangement (the "Warrant Debt") with a zero interest rate, a fixed maturity date and a feature that makes the debt convertible to common stock. The Warrant Debt had a fair value of $80 thousand at the time of issuance. The derivative had a fair value of $136 thousand. The conversion feature is an embedded derivative; thus, for accounting purposes, the conversion feature is bifurcated and accounted for separately from the PFG Debt and Warrant Debt as a derivative liability measured at fair value at each reporting period.

At December 31, 2016, the estimated fair value of the derivative liability associated with the warrants issued in connection with the Loan and Security Agreement, was $46 thousand compared to $67 thousand at September 30, 2016. The change in the fair value of the derivative liability for the three months ended December 31, 2016, was recorded as a gain of $21 thousand included in the other income (expense).
The proceeds from the Loan and Security Agreement were allocated between the PFG Debt and the Warrant Debt (inclusive of its conversion feature) based on their relative fair value on the date of issuance which resulted in carrying values of $1.784 million and $216 thousand, respectively. The conversion feature of $216 thousand is treated together as a debt discount on the PFG Debt and will be accreted to interest expense under the effective interest method over the three-year term of the PFG Debt and the five-year term of the Warrant Debt. For the three months ended December 31, 2016, the Company recorded accretion of discount expense associated with the warrants issued with the PFG loan of $5 thousand as well as $18 thousand related to amortization of the debt discount in each respective period. The Company recorded accretion of discount expense of $3 thousand, as well as $15 thousand related to amortization of the debt discount in the three months ended December 31, 2015. At December 31, 2016, the fair values of the PFG Debt and the Warrant Debt (inclusive of its conversion feature) were $1.041 million and $153 thousand, respectively.

The fair values of term debt and warrant debt are based on the present value of expected future cash flows and assumptions about current interest rates and the creditworthiness of the Company (Level 3). At December 14, 2015, the carrying amounts of the Company's term debt and warrant debt totaled $1.784 million and $216 thousand, respectively. At December 14, 2015, the Company's term debt and warrant debt were recorded at fair value. At December 31, 2016, the derivative liability was remeasured at fair value. The fair value of the bifurcated conversion feature represented by the warrant derivative liability is based on a Black Scholes option pricing model with assumptions for stock price, exercise price, volatility, expected term, risk free interest rate and dividend yield similar to those described previously for share-based compensation which were generally observable (Level 2).

At December 31, 2016, a balance of $1.1 million was outstanding on the term debt with PFG, with an effective interest rate of ten-and-three-quarters percent (10.75%). At September 30, 2016, a balance of $1.3 million was outstanding with PFG.
The Term Loan is collateralized by substantially all the Company's assets, including intellectual property, subject to a first lien held by Silicon Valley Bank, The Term Loan requires compliance with the same financial covenants as set forth in the loan from Silicon Valley Bank. At December 31, 2016, the Company was not in compliance with the

Minimum EBITDA financial covenant in the Loan and Security Agreement. On February 8, 2017, the Company and PFG entered into a Modification No. 2 to the Loan and Security Agreement ("Modification No. 2"). Under Modification No. 2: (i) waives the Minimum EBITDA covenant default for December 31, 2016 (ii) the Liquidity covenant was modified to require minimum Liquidity (as defined) with respect to the Company only, on a monthly basis, of at least 1.60:1.00 for the first and second month of each quarterly fiscal period; and 1.75:1.00 for the third month of each quarterly fiscal period, replacing the previous Liquidity requirement of 1.5:1.0 for each month-end.

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Other Indebtedness
At December 31, 2016, a balance of $428 thousand was outstanding on the line of credit with Mitsui Sumitomo Bank. At September 30, 2016, a balance of $198 thousand was outstanding on the line of credit. The notes and credit facility are both related to Mediasite K.K., and both accrue interest at an annual rate of approximately one-and-one half percent (1.575%).
At December 31, 2016, there was no outstanding balance on the subordinated note payable related to the acquisition of Sonic Foundry International (formerly MediaMission), with an annual interest rate of six-and-one half percent (6.5%). At September 30, 2016, the outstanding balance was $93 thousand.
In the three months ended December 31, 2016, a foreign currency gain of $6 thousand was realized related to re-measurement of the subordinated notes payable related to the Company's foreign subsidiaries. In the three months ended December 31, 2015, a foreign currency gain of $6 thousand was recorded related to the remeasurement of the subordinated notes payable.
5. Income Taxes
The Company's practice is to recognize interest and/or penalties related to income tax matters in income tax expense. The Company had no accruals for interest and penalties on the Company's Condensed Consolidated Balance Sheets at December 31, 2016 or September 30, 2016, and has not recognized any interest or penalties in the Condensed Consolidated Statements of Operations for either of the three months ended December 31, 2016 or 2015, respectively.
6. Goodwill and Other Intangible Assets
The changes in the carrying amount of goodwill for the three months ended December 31, 2016 are as follows:

Balance at September 30, 2016	$11,310
Foreign currency translation adjustment	(448)
Balance at December 31, 2016	$10,862

7. Subsequent Events
On February 8, 2017, the Company and PFG entered into a Modification No. 2 to the Loan and Security Agreement ("Modification No. 2"). Under Modification No. 2: (i) waives the Minimum EBITDA covenant default for December 31, 2016 (ii) the Liquidity covenant was modified to require minimum Liquidity (as defined) with respect to the Company only, on a monthly basis, of at least 1.60:1.00 for the first and second month of each quarterly fiscal period; and 1.75:1.00 for the third month of each quarterly fiscal period, replacing the previous Liquidity requirement of 1.5:1.0 for each month-end.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Risks and Uncertainties
This report includes estimates, projections, statements relating to our business plans, objectives, and expected operating results that are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements may appear throughout this report, including the following sections: "Management's Discussion and Analysis," and "Risk Factors." These forward-looking statements generally are identified by the words "believe," "project," "expect," "anticipate," "estimate," "intend," "strategy," "future," "opportunity," "plan," "may," "should," be," "will continue," "will likely result," and similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially. We describe risks and uncertainties that could cause actual results and events to differ materially in "Risk Factors" (Part I, Item 1A of the Company's Annual Report on Form 10-K for the Fiscal Year ended September 30, 2016 and Part II, Item 1A of this Form 10-Q), "Quantitative and Qualitative Disclosures about Market Risk" (Part I, Item 3 of this Form 10-Q and Part II, Item 7A of the Company's Annual Report on Form 10-K for the Fiscal Year ended September 30, 2016), and "Management's Discussion and Analysis" (Part I, Item 2 of this Form 10-Q). We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

Overview

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Sonic Foundry, Inc. is a trusted global leader for video capture, management and webcasting solutions in education, business and government. The patented Mediasite Video Platform transforms communications, training, education and events for our customers.

RESULTS OF OPERATIONS

Revenue

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

Q1-2017 compared to Q1-2016

Revenue in Q1-2017 increased $216 thousand, or 2% to $9.3 million, from Q1-2016 revenue of $9.1 million. Revenue consisted of the following: