

# SECURITIES & EXCHANGE COMMISSION EDGAR FILING

## Sonic Foundry

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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, 2003

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**

(State or other jurisdiction of  
incorporation or organization)

**39-1783372**

(I.R.S. Employer Identification No.)

**222 W. Washington Ave, Suite 775, Madison, WI 53703**

(Address of principal executive offices)

**(608) 256-3133**

(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 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

The aggregate market value of the voting stock held by non-affiliates of the Registrant's was approximately \$48,212,000 based on the last sale price on December 19, 2003.

The number of shares outstanding of the issuer's common equity was 29,308,201 as of December 19, 2003.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the 2004 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, 2004.

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**IN ADDITION TO HISTORICAL INFORMATION, THIS ANNUAL REPORT ON FORM 10-K CONTAINS FORWARD-LOOKING STATEMENTS SUCH AS STATEMENTS OF THE COMPANY'S EXPECTATIONS, PLANS, OBJECTIVES AND BELIEFS. THESE STATEMENTS USE SUCH WORDS AS "MAY," "WILL," "EXPECT," "ANTICIPATE," "BELIEVE," "PLAN" AND OTHER SIMILAR TERMINOLOGY. ACTUAL RESULTS COULD DIFFER MATERIALLY DUE TO CHANGES IN THE MARKET ACCEPTANCE OF SONIC FOUNDRY'S PRODUCTS OR SERVICES, MARKET INTRODUCTION OR PRODUCT DEVELOPMENT DELAYS, GLOBAL AND LOCAL BUSINESS CONDITIONS, LEGISLATION AND GOVERNMENTAL REGULATIONS, COMPETITION, THE COMPANY'S ABILITY TO EFFECTIVELY MAINTAIN AND UPDATE ITS PRODUCT OR SERVICE PORTFOLIO AND SHIFTS IN TECHNOLOGY.**

**PART I**

**ITEM 1. BUSINESS**

Sonic Foundry, Inc. is in the business of developing automated rich-media application software and systems, (our "Media Systems" business). The Media Systems 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. ("MediaSite"). 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 and, in some cases, patented 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). The core products include MediaSite Live ("MSL") a web presentation and webcasting system and Publisher, a software product for creating accessible and searchable rich media presentations.

Sonic Foundry, Inc., the parent company of our Media Systems 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., Suite 775, Madison, Wisconsin, 53703 and our telephone number is (608) 443-1600. Our corporate website is <http://www.sonicfoundry.com>. Electronic access to our SEC filings is available at the "Investor Information" section of our website.

Until recently, we were engaged in three businesses – Media Services, Desktop Software and Media Systems.

Our media services operations (the "Media Services" business) was a mature business that was a result of several acquisitions we made over recent years - performed primarily through two subsidiaries of Sonic Foundry, Inc.: Sonic Foundry Media Services, Inc. and International Image Services Corporation, Inc. d/b/a Sonic Foundry Media Services. Media Services provided format conversion, tape duplication, film restoration and other services to the media, broadcast and entertainment industries. The media services included translating analog or digital tapes, CDs, films and other audio and video media into various compression and Internet streaming file formats, including multiple compression rates. Add-on services involved cleaning or filtering recordings for improved quality. On May 16, 2003, we completed the sale of the Media Services business for approximately \$5.6 million, including an estimate of the value of net working capital acquired. In fiscal 2002, our Media Services business generated revenue of \$9.4 million, or approximately 36% of our total revenues. All revenue and expenses included in the results of operations of the Media Services business have been presented as discontinued operations (the "Discontinued Operations") and previously reported consolidated financial statements have been restated to reflect the discontinued operations presentation.

Our desktop software operations (the "Desktop Software" business) designed, developed, marketed and supported software products for digitizing, converting, editing and publishing of audio, video, and/or multimedia content. The Desktop Software business included a number of mature products such as Sound Forge, ACID and Vegas. In 2002, annual revenue from our Desktop Software business was \$15.9 million, or approximately 61% of our total revenues. We entered into an amended and restated asset purchase agreement to sell the Desktop Software business dated June 6, 2003 and effective May 2, 2003 with a subsidiary of Sony Pictures Digital. The transaction was completed on July 30, 2003 following shareholder approval on July 29, 2003.

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## **Business and Industry Background**

Most organizations have a need to communicate, not just internally but externally, beyond the boundaries they've initially set up. In the case of universities and colleges, connecting to online lectures and materials is becoming a must have. 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. And 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.

Reinforcing this need are the economics behind communication. More and 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 currently offer an easy to use, simple-to-deploy, entry-level system for delivering and archiving real-time web-based presentations and webcasts. This offering provides significant advantages related to creating and viewing the content. Our uniqueness is best understood through an appreciation of the way we've moved the content through the publishing workflow process, while still delivering a viewing experience that does not require proprietary software or subprograms that various web services use for deploying graphics ("Applets") or software other than standard Windows media.

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 MSL delivers an elegant, easy to implement solution that shows the promise of breaking through traditional barriers of content production.

In many ways, the MSL appliance has the characteristic of an Internet projector. Just as projectors first extended overhead slides and Powerpoint presentations to the screen, the Live box 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 MSL as a media event recorder. Our device is being used to capture critical communications and acts as an archiving tool. In some instances, MSL is being used as a knowledge capture device capable of archiving presentations. In general, we're finding that our customers predominantly use MSL 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.

## **Media Systems Products and Services**

During fiscal 2003, we introduced two versions of our MSL web presentation and webcasting system to the enterprise marketplace. MSL 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. MSL is a unique combination of hardware and software that automatically takes multiple media feeds (video, audio and graphics) from a variety of presentation devices and combines them into an Internet "stream". This stream can be distributed Live to remote users, as the presentation is occurring, thereby eliminating the entire authoring process. Similarly, following the creation of the presentation, the stream is made accessible on-demand from a website. Our latest engineering effort - version 3 of MSL, released on November 3, 2003 – made further enhancements to the product line including CD burning, enhanced security, Macintosh browser support, and digital video capture.

The engineering put into the product was 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 minimal 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 setting and is primarily why we chose the audio / video ("A/V") reseller channel as our primary

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distribution partner. Because many of the technology hurdles and use issues have been solved through an IP approach, we believe the web presentation and webcasting markets will expand far beyond the established video conferencing market.

We are also involved in advanced research related to the interpretation and further enhancement of rich media. A significant portion of this research is based on patented technology defined as the integration of speech, language and image processing (ISLIP) which 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. This technology was recognized in 2001 by MIT Technology Review as one of the "Ten Emerging Technologies That Will Change the World". Another patented technology "video skimming" provides users the capability of reviewing rich media faster than real-time. With continued funding being received from government entities, we are actively researching and developing further commercialization efforts of these technologies and applying the resulting products to broader market opportunities. On October 20, 2003, we announced the receipt of a grant from the United States Department of Justice for a 18-month project to examine how state and local law enforcement agencies can better process and manage audio and video media. We will then develop a set of media analysis software components that will 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. We believe the outcome of our research and commercialization efforts will advance the art of "meta-tagging" (identification and extraction of audio, visual and textual cues) as well as "video mining" technology. This will allow us to offer technologies that both produce and consume rich-media content at a more personalized and more interactive level.

MediaSite 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.

Product line expansion—Software engineering on the product line continues to expand the scale and scope of our offerings. Development efforts are targeted towards enhancing content access and viewing choices. Similarly, some of our advanced technologies are expected to be incorporated in making our content much more navigable and searchable, versus non-indexed media content. Fundamentally, without accurate and full indexes available, viewing media would be analogous to reading a text book with no chapters, no indexes and no cross references, making it very time-consuming.

Service contracts—We offer our customers support for our Live product through annual maintenance contracts. The contracts are purchased by the majority of our customers at the time the Live product is purchased at a price of 18% of the Live list price and includes an extension of the hardware warranty from the standard 90-days to one year, prioritized unlimited technical support via phone or email, access to the support website, access to product hot fixes and maintenance releases and documentation.

### **Selling and Marketing**

We sell and market our offerings through a sales force that manages a reseller channel of Value-added resellers, system integrators 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. To date, we have brought on roughly 40 resellers who have demonstrated these qualifications. This group is based almost entirely in the United States and sells primarily to customers we've identified as having the greatest potential: presenters, trainers, lecturers, marketers and leaders who have a routine need to communicate to many people in the higher education, government, health and certain corporate markets. As the product line begins to show growth trends in the U.S. market, we expect to expand our reseller network to the worldwide market. Revenue from our largest customer was just under 10% in 2003 and from our two largest customers were 29% and 25%, respectively, in 2002.

Vertical market expansion—Currently, we realize the majority of our revenues from the education and distance learning markets. Corporations currently lag these users in adoption, but are expected to grow significantly as market awareness of web presentation and conferencing solutions expand. Similarly, we are seeing expanded interest from government, professional membership, legal, medical, engineering and marketing organizations. Targeting each group specifically offers an opportunity to build new markets as others become more established.

Repeat orders—Most customers will buy a single system 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

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specifically targeted larger entities that have more than 500 employees and multiple offices and that have found service provider solutions in conferencing far too cost prohibitive.

**Renewals**—As is typical in the industry, we expect to offer services 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 are in the early stages of building out our database of potential customers in the government, education and corporate marketplaces. We have established a selected process of targeting specific verticals that have a direct and demonstrated need for our offerings.

## **Operations**

We contract with a third party to build the hardware of our Live 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 digital media marketplace is new, rapidly evolving and intensely competitive. As more companies begin to leverage streaming video technologies, we expect competition to intensify. We currently compete directly with other providers in the market for web-based video solutions including Convera Corporation, Autonomy and Yahoo! Broadcast Solutions. 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 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 intranet streaming video business.

### **Intellectual Property**

We depend on our ability to develop and maintain the proprietary aspects of our technology. To protect our proprietary technology, we rely primarily on a combination of patent, trademark and copyright laws, as well as confidentiality and license agreements with our employees and others. We actively seek patent protection for our intellectual property. We have filed four U.S. patent applications on our proprietary technology. None of these patents have been issued by the Patent and Trademark Office.

We have filed for four U.S. and four foreign country trademarks, of which two U.S. and three foreign country trademarks are registered. We seek to avoid disclosure of our trade secrets by limiting access to our proprietary technology and restricting access to our source code. Despite these precautions, it may be possible for unauthorized third parties to copy particular portions of our technology or reverse engineer or obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect proprietary rights to the same extent as the laws of the United States. Our means of protecting our proprietary rights in the United States or abroad may not be adequate and competing companies may independently develop similar technology.

### **Research and Development**

We believe that our future success will depend in part on our ability to continue to develop new, and to enhance our existing Systems business. Accordingly, we invest a significant amount of our resources in research and development activities. During the fiscal years ended September 30, 2003 and 2002, we spent \$1.7 million and \$3.1 million on internal research and development

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activities for our systems business. These amounts represent 138% and 358% of total Media Systems 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 which includes the underlying technology of our current MediaSite Publisher and MSL products for a total of \$9.1 million. MediaSite 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, 2003, 2002 and 2001, we had 32, 246 and 239 full-time employees, respectively. All of these employees were employed in our Systems business in 2003, while 46 were employed in the Systems business as of September 30, 2002 and none of these employees were employed in our systems business in 2001. Full time employees of our Media Services and Desktop Software businesses were terminated upon completion of the sales in May and July, 2003, respectively. The majority of employees associated with both businesses were hired by the buyers. 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 2. PROPERTIES**

Our principal office is located in Madison, WI in a leased facility of approximately 6,000 square feet. The building serves as our corporate headquarters, accommodating our G&A, R&D and Sales and Marketing departments. We believe this facility is adequate and suitable for our needs.

In addition, we lease 9,000 square feet in a facility in Wexford Pennsylvania and 7,000 square feet in a building in downtown Pittsburgh, Pennsylvania. The Wexford lease ends in January 2003. We are attempting to sublet or negotiate a settlement for the space in downtown Pittsburgh.

**ITEM 3. LEGAL PROCEEDINGS**

None

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

The Annual Meeting of Stockholders was held on July 29, 2003. A quorum consisting of approximately 90% of our 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 consider and vote on a proposal to approve (A) the Amended and Restated Asset Purchase Agreement, dated as of June 6, 2003 and effective as of May 2, 2003 (the "Amended and Restated Asset Purchase Agreement"), by and between SP Acquisition Company, a corporation formed under the laws of Delaware ("SPA") and an indirect wholly-owned subsidiary of Sony Pictures Digital Inc., a Delaware corporation ("SPD"), and Sonic; and (B) the sale of the Desktop Software Business of Sonic as contemplated by the Amended and Restated Asset Purchase Agreement (the "Proposed Transaction") which constitutes a sale of substantially all of the assets of Sonic pursuant to Maryland General Corporation Law ("MGCL");
2. To approve an amendment of Sonic's charter upon the determination by Sonic's Board of Directors to approve a reverse stock split of Sonic's common stock, par value \$.01 per share (the "Common Stock") in the ratio of one-for-ten at any time prior to June 1, 2004 the ("Reverse Stock Split").
3. To elect one director to hold office for a term of five years, and until his successor is duly elected and qualified.
4. To ratify the appointment of Ernst & Young LLP as our independent auditors for the fiscal year ending September 30, 2003.

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

The results of the proposals are as follows:

	For	Against	Abstain/Withheld
Proposal #1	20,378,326	310,230	65,767
Proposal #2	25,425,071	1,866,818	68,577
Proposal #3	26,288,859	943,810	127,797
Proposal #4	27,273,248	43,021	44,197

**PART II**

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

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
<b>Year Ended September 30, 2004:</b>		
First Quarter (through December 15, 2003)	\$2.72	\$1.70
<b>Year Ended September 30, 2003:</b>		
First Quarter	0.90	0.10
Second Quarter	0.60	0.32
Third Quarter	1.45	0.27
Fourth Quarter	2.74	0.72
<b>Year Ended September 30, 2002:</b>		
First Quarter	4.44	1.00
Second Quarter	3.27	2.04
Third Quarter	2.57	1.14
Fourth Quarter	1.40	0.56

In October 2001, our common stock failed to maintain a minimum bid price of \$1.00 per share for at least 10 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 that we now demonstrated 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 10, 2003 there were 484 common stockholders of record. Many shares are held by brokers and other institutions on behalf of shareholders.

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**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	2,129,959	\$ 3.89	593,087
Equity compensation plans not approved by security holders	2,940,119	1.27	492,036
Total	5,070,078	\$ 2.37	1,085,123

**RECENT SALES OF UNREGISTERED SECURITIES**

None.

**ITEM 6. SELECTED FINANCIAL DATA**

The selected financial and operating data as of and for the years ended September 30, 2003, 2002, 2001, 2000 and 1999 were derived from our financial statements that have been audited by Ernst & Young LLP, independent auditors. 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,				
	2003	2002	2001	2000	1999
<b>Statement of Operations Data:</b>					
Revenues	\$ 1,264	\$ 859	—	—	—
Gross profit	376	479	—	—	—
Loss from operations	(7,530)	(7,876)	\$ (2,624)	\$ (3,349)	\$(1,816)
Loss from continuing operations before cumulative effect of change in accounting principle	(7,549)	(8,314)	(2,085)	(2,254)	(957)
Loss from operations of discontinued operations	(2,930)	(3,691)	(47,775)	(32,668)	(5,040)
Gain on disposal of discontinued operations	11,932	—	—	—	—
Cumulative effect of change in accounting principle	—	(44,732)	—	—	—
Net income (loss)	\$ 1,453	\$(56,737)	\$ (49,860)	\$ (34,922)	\$ (5,997)

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Income (loss) per common share before cumulative effect of change in accounting principle:					
Continuing operations	\$ (0.27)	\$ (0.31)	\$ (0.09)	\$ (0.12)	\$ (0.17)
Discontinued operations	0.32	(0.14)	(2.16)	(1.77)	(0.89)
Cumulative effect of change in accounting principle	—	(1.67)	—	—	—
 Basic net income (loss) per common share	 \$ 0.05	 \$ (2.12)	 \$ (2.25)	 \$ (1.89)	 \$ (1.06)
 Diluted net income (loss) per common share	 \$ 0.05	 \$ (2.12)	 \$ (2.25)	 \$ (1.89)	 \$ (1.06)
 Weighted average common shares: - Basic	 27,794	 26,812	 22,129	 18,503	 5,687
- Dilutive	28,375	26,812	22,129	18,503	5,687
  <b>2003</b>	  <b>2002</b>	  <b>2001</b>	  <b>2000</b>	  <b>1999</b>	
 <b>Balance Sheet Data at September 30:</b>					
Cash and cash equivalents	\$12,623	\$ 3,704	\$ 7,809	\$ 21,948	\$ 5,889
Working capital (deficit)	11,025	(496)	4,421	22,153	8,843
Total assets	22,801	27,643	71,683	126,825	16,709
Total indebtedness	48	5,263	5,961	8,403	5,283
Stockholders' equity	20,231	17,984	61,231	110,366	8,747

### RISK FACTORS

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

#### WE HAVE NO MEANINGFUL OPERATING HISTORY IN OUR MEDIA SYSTEMS BUSINESS ON WHICH TO EVALUATE OUR OPERATIONS OR PROSPECTS.

We have only been engaged in our Media Systems business since October 2001. Accordingly, there is no significant business history on which you can base an evaluation of our Media Systems business and its prospects. Our Media Systems business must therefore be evaluated in light of the risks, uncertainties, expenses and difficulties frequently encountered by companies in their early stages of development, particularly companies in new and evolving markets. These risks include the following with respect to our Media Systems business:

- substantial dependence on systems and our Live product in particular with only limited market acceptance;
- need to develop sales and support organizations;
- competition;
- need to manage changing operations;
- reliance on strategic relationships;
- customer concentration; and
- dependence on hardware suppliers and reduced gross margins associated with bundled systems.

#### WE ANTICIPATE INCURRING LOSSES FOR THE FORESEEABLE FUTURE.

For the year ended September 30, 2003, the Media Systems business had a gross margin of \$376 thousand on revenues of \$1.3 million with which to cover sales, marketing, research, development and general administrative costs. Our sales, marketing, research, development and general administration costs are a large multiple of the revenues from our orders, 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, 2003, these expenses were over 6 times our total revenues. Although we expect our operating losses as a percentage of revenues to decline significantly in the near future, we expect them to continue to exceed our gross margin for the foreseeable future and we may never achieve profitability.

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**WE MAY NOT EARN REVENUES SUFFICIENT TO REMAIN IN BUSINESS.**

Our ability to generate revenue has been significantly reduced following the sale of our Desktop Software business that previously comprised approximately 65 percent of our revenues and the sale of our Media Services business which comprised approximately 32 percent of our revenues. Our ability to become profitable depends on whether we can sell our systems 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 systems operations;
- The extent to which consumers and businesses use our systems; and
- Our ability to price our offerings in order to give us adequate margins.

Because of the recession in the technology market, the early stage of our Media Systems business, and the evolving nature of our business, we cannot predict whether our revenue model will prove to be viable, whether demand for our systems 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 MAY NEED TO RAISE ADDITIONAL CAPITAL IF WE DO NOT QUICKLY BECOME PROFITABLE.**

Our cash used in operating activities was approximately \$4.1 million for the year ended September 30, 2003. Based on our cash balance at September 30, 2003 of \$12.6 million, we anticipate having sufficient working capital for at least the next twelve months. However, if we do not become profitable or our losses increase, we may need additional capital. The current 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 HAVE ALLOCATED SIGNIFICANT PRODUCT DEVELOPMENT, SALES AND MARKETING RESOURCES TOWARD THE DEPLOYMENT OF OUR MEDIA SYSTEMS PRODUCTS, WE FACE A NUMBER OF RISKS THAT MAY IMPEDE MARKET ACCEPTANCE OF THESE PRODUCTS AND SUCH RISKS MAY ULTIMATELY PROVE OUR BUSINESS MODEL INVALID, THEREBY HURTING OUR FINANCIAL RESULTS.**

We have invested significant resources into developing and marketing our Media Systems products and do not know whether our business model and strategy will be successful. The market for these products is in a relatively early stage and one of our key assumptions about the market is that digital video will continue to develop as a more relevant communication medium. We cannot predict how the market for our Media Systems 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 Media Systems 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.

In addition, resources may be required to fund development of our Media Systems products' feature-sets beyond what we have planned due to unanticipated marketplace demands. We may determine that we are unable to fund these additional feature-sets due to financial constraints and may halt the development of a product at a stage that the marketplace perceives as immature. We may also encounter that the marketplace for a Media System product is not as robust as we had expected and we may react to this by leaving the development of a product at an early stage or combining key features of one or more of our Media Systems products into a single product. Either of these product development scenarios may impede market acceptance of any of our Media Systems products and therefore hurt our financial results.

**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

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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 license our products. In general, the process of selling our systems 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 Media Systems 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 Media Systems 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 Media Systems products will occur and this could cause significant variations in our operating results.

**OUR REVENUES MAY BE HARMED IF GENERAL ECONOMIC CONDITIONS DO NOT IMPROVE.**

Our revenues are dependent on the health of the economy (in particular, the robustness of information technology spending) and the growth of our customers and potential future customers. The economic environment has not been favorable to companies involved in information technology infrastructure for several quarters. In addition, conflicts with countries such as Iraq create a great deal of uncertainty for businesses and this uncertainty generally results in businesses delaying investments in such areas as information technology. If the economic trend continues, our customers and potential customers may continue to delay or reduce their spending on our software and service solutions. When economic conditions for information technology products weaken, sales cycles for sales of software products and related services tend to lengthen and companies' information technology and business unit budgets tend to be reduced. Although we believe that economic conditions have improved somewhat over the past few months, if the economy weakens again or the conflict with Iraq or other countries worsens, our revenues could suffer and our stock price could decline.

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

The market for digital media systems 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 are received more favorably in the marketplace, a new approach or technology is developed or an existing or new competitor markets more effectively than us or we otherwise do not compete effectively, our business will be harmed. In addition, the more successful we are in the emerging market for media systems, 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.

**DUE TO OUR LICENSE AGREEMENT WITH CARNEGIE MELLON UNIVERSITY, WE MAY FACE COMPETITION IN OUR PUBLISHER(TM) PRODUCT AND WE MAY LOSE THE ABILITY TO SELL THAT PRODUCT IN THE FUTURE.**

Our Publisher(TM) product, is based in part on licensed technology from Carnegie Mellon. As part of our acquisition of MediaSite's assets in October 2001, we acquired a nonexclusive license to use certain technology in that product and negotiated an exclusive license (the "License Agreement") as to certain competitors. Because the exclusivity is limited to a defined list of competitors, a risk exists that Carnegie Mellon could license the technology to another party that is not currently a named competitor, but could become competitive with us. Moreover, if the License Agreement were to terminate before the underlying patents expired, we would lose the ability to sell the products covered by the License Agreement.

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**WE LACK PERSONNEL TO EFFICIENTLY GROW OUR BUSINESS.**

Due to the start-up nature of our business and our need to manage cash flow, we currently do not have a sufficient number of employees to efficiently grow our business. Our engineering staff is currently attempting to respond to the many demands to add features to our systems offering. Also, our sales staff is currently attempting to identify appropriate customer targets. Our failure to respond to engineering and sales needs by either adding additional personnel or by efficiently allocating existing personnel will harm our business.

**OUR DISTRIBUTION CHANNELS ARE NEW AND UNPROVEN.**

Audio/visual distributors have not committed to our systems products. Because our systems products are complicated, we may have difficulty in obtaining such commitments. In addition, Tandberg and Polycom, two prominent distributors, 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, our business could be harmed.

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

The technology underlying our systems 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, services and systems 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 errors and omissions coverage may not be sufficient to cover our complete liability exposure.

**MANY POTENTIAL CUSTOMERS MAY NOT RESPOND TO OUR WINDOWS-BASED OPERATING SYSTEM OR OUR CONTENT VIEWING AND STREAMING FORMATS.**

The streaming format and security features found in MSL are based to a large extent on Microsoft technology and Windows Media. The combination of our engineering work and the utilization of Microsoft's technology platform allow us to deliver this end to end content creation engine and develop further technologies in as rapid a fashion as possible. However, certain customers have been requesting other streaming formats, third party browser support, or third party operating system support. Likewise, Microsoft's server solutions are typically viewed as middle market products, but are not yet generally utilized in mission critical large enterprise deployments. Our inability to respond to customer requests for different operating systems, content viewing or streaming formats may harm our business.

**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.

**SERIAL BUYING MAY FAIL TO MATERIALIZE.**

We need to sell multiple units to educational and corporate institutions in order to become profitable. While we have addressed a strategy to accomplish this, there can be no assurances we will be successful.

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**OUR SECURITY SYSTEMS MAY NOT BE ADEQUATE.**

Hacking is an endemic problem in the software industry. We need to provide protection against hackers, and we may not be able to do so. Our failure to provide protection against hackers may 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.

**WE MAY NOT BE SUCCESSFUL IN PROTECTING OUR INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS.**

Our inability to protect our proprietary rights, and the costs of doing so, could harm our business. Our success and ability to compete partly depends on the superiority, uniqueness or value of our technology, including both internally developed technology and technology licensed from third parties. To protect our proprietary rights, we rely on a combination of trademark, patent, copyright and trade secret laws, and confidentiality agreements with our employees and third parties. Recently, we have undertaken additional efforts to identify which of our proprietary processes and algorithms may be patentable, and we currently have several patent applications pending with the U.S. Patent and Trademark Office. If patents are not issued as a result of any of these applications, or if we cannot afford to enforce them, other parties may infringe on our proprietary rights.

Despite our efforts to protect our proprietary rights, unauthorized parties may copy or infringe aspects of our technology or trademarks, or obtain and use information we regard as proprietary. In addition, others may independently develop technologies that are similar or superior to ours, which could reduce the value of our intellectual property.

Companies in the computer industry have frequently resorted to litigation regarding intellectual property rights. We may have to litigate to enforce our intellectual property rights or to determine the validity and scope of other parties' proprietary rights.

**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 has traded below \$1.00 within the last several months, 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.

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As of December 10, 2003, we had outstanding options and warrants to acquire 6,693,120 shares of common stock, 917,741 of which are subject to future vesting. Included in the foregoing are 4,226,124 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, 3,308,383 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.

**RECENTLY ENACTED AND PROPOSED CHANGES IN SECURITIES LAWS AND REGULATIONS WILL INCREASE OUR COSTS AND MAY MAKE IT MORE DIFFICULT FOR US TO ATTRACT AND RETAIN OFFICERS AND DIRECTORS.**

The Sarbanes-Oxley Act ("the Act") of 2002 that became law in July 2002 requires changes in some of our corporate governance and securities disclosure and/or compliance practices. The Act also requires the SEC to promulgate new rules on a variety of subjects, in addition to rule proposals already made. We believe these developments will increase our legal and accounting compliance costs. We also expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These developments could make it more difficult for us to attract and retain qualified members of our board of directors, or qualified executive officers. We are presently evaluating and monitoring regulatory developments and cannot reliably estimate the timing or magnitude of additional costs we will incur as a result of the Act or other, related legislation.

**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.

**SUBSTANTIAL SALES OF OUR COMMON STOCK COULD LOWER OUR STOCK PRICE.**

Sales of a substantial number of shares of common stock in the public market, including 3.6 million shares issued to the former stockholders of MediaSite, Inc., which we registered in 2002, or the perception that these sales may occur, could adversely affect the market price of the common stock by potentially introducing a large number of sellers of our common stock into a market in which the common stock price is already volatile, thus driving the common stock price down. In addition, the sale of these shares could impair our ability to raise capital through the sale of additional equity securities.

**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

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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 five directors each year. Moreover, Maryland corporate law restricts certain business combination transactions with "interested stockholders."

**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.

**Overview**

Our Media Systems business develops automated rich-media applications and scalable solutions that allow media owners—including entertainment companies, educational institutions, corporations and government organizations—to deploy, manage, index and distribute video content on IP-based networks.

**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 and;
- Impairment of long-lived assets.

*Revenue Recognition and Allowance for Doubtful Accounts*

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

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

*Impairment of long-lived assets*

We assess the impairment of goodwill 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". SFAS 144 requires that long-lived

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assets and intangible assets other than goodwill be 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.

## **RESULTS OF OPERATIONS**

Our systems business was established in fiscal 2002 upon the acquisition of MediaSite in October 2001. Our Media Services and Desktop Software businesses were sold in fiscal 2003 and reported under the caption of discontinued operations. Therefore, our 2001 results do not include any revenues nor cost of revenues and our operating expenses reflect only general overhead expenses not allocated to our discontinued Media Services and Desktop Software businesses. The sale of our Media Services and Desktop Software businesses significantly affect 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**

Revenue from our Media Systems business include the sales of our MediaSite Live product and related customer support contracts sold separately as well as fees charged for the licensing of software products and custom software development. The primary focus is on the platforms of MediaSite Publisher™ and MediaSite Live™. These products are marketed to government agencies, educational institutions, and corporations who need to deploy, manage, index and distribute video content on IP-based networks. We reach both our domestic and international markets through reseller networks, a direct sales effort and partnerships with system Integrators.

#### **2003 compared to 2002**

Revenue increased \$405 thousand, or 47%, from \$859 thousand in 2002 to \$1.3 million in 2003.

- Product sales represent shipments of our MediaSite Live product, which was first released in June 2002, and accounted for \$1.2 million of revenues in fiscal 2003 and \$206 thousand in \$2002.
- Customer support revenue represents a portion of fees collected for MediaSite Live service contracts and amortized over the length of the contract, typically 12 months. Revenue of \$84 thousand from MediaSite Live related support and service contracts was recorded in 2003 and \$12 thousand in 2002. At September 30, 2003 \$194 thousand of unrecognized support revenues remained in unearned revenues.
- Other revenue relates to freight charges billed separately to our customers and software licensing fees for our Publisher product and certain custom software engineering projects. Other than freight costs, no other revenues were recorded in 2003.
  - MediaSite Publisher sales were \$368 thousand in 2002. Over half of the Publisher revenues in 2002 represent what we believe to be the first stage of a relationship with a system integrator selling to a unit of the Federal Government, from which we expect to generate additional license and support revenues in fiscal 2004.
  - Custom development for a Federal agency accounted for \$252 thousand of revenue in 2002. This contract was completed in May 2002. Total Federal government system software revenue totaled \$538 thousand in 2002. We were recently awarded a \$496 thousand grant with the Department of Justice to perform similar custom development project work in fiscal 2004 and 2005.

#### **Gross Margin from Systems Software**

The significant components of cost of systems include:

- Cost of hardware that is bundled with MediaSite Live. Live sales should typically result in gross margins of approximately 60% - 70%.
- Amortization of MediaSite acquisition amounts assigned to purchased technology and other identified intangibles. We will be amortizing approximately \$83 thousand per quarter over the next 3 years for the identified intangibles of the MediaSite purchase.
- A 5% royalty on sales of MediaSite Publisher's technology.

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Margins are expected to increase in the near term as: total revenues increase, non-cash amortization of purchased technology costs remains constant, and as the mix of revenues reflects a greater percentage of higher margin post contract support, consulting and publisher 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.

**2003 compared to 2002**

Selling and marketing expenses increased by \$427 thousand, or 17%, to \$3.0 million in 2003 from \$2.5 million in 2002, primarily attributable to the following:

- \$300 thousand severance due to the Q1-2003 termination of two executives involved in the systems efforts.
- \$100 thousand increase in selling and marketing compensation expense.
- \$115 thousand decline in public relations spending related to the government channel.
- \$70 thousand increase in travel and trade show costs for sales personnel.

Selling and marketing costs are expected to increase at a lower growth rate than revenues in the future.

**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.

**2003 compared to 2002**

G&A expenses increased \$461 thousand, or 17%, from \$2.7 million in 2002 to \$3.2 million in 2003. The increase is due to:

- A \$300 thousand charge to accrue the remaining anticipated net costs through the expiration of the two Pittsburgh, PA facilities no longer utilized.
- \$80 thousand bad debt expense related to two former Publisher customers.

**2002 compared to 2001**

G&A expenses in 2001 reflect general corporate overhead not included in operations of our discontinued Desktop Software and Media Services businesses.

**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.

**2003 compared to 2002**

R&D expenses decreased \$1.3 million, or 43%, from \$3.1 million in 2002 to \$1.7 million in 2003. Attrition and workforces reductions of the now closed Pittsburgh location accounted for \$900 thousand of the change. The reduction in staff reflects a decision to focus on the newer MediaSite Live product and offer no near term upgrades of the MediaSite Publisher product.

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**Other Income (Expense)**

Other expense in 2002 was impacted by the \$514 thousand write-off of long-term investment, and interest income of \$88 thousand. Other income of \$539 in 2001 represents interest income when interest rates were higher and the Company had higher cash balances.

**Discontinued Operations**

In the fall of 2002, the Company determined that operations of our Desktop Software and Media Services business would not provide sufficient cash flow along with our existing cash reserves to fund planned growth of the systems division and make remaining subordinated debt payments. In response, the Company retained an advisor to evaluate the sale of certain operating assets. On May 16, 2003, we completed the sale of the assets used in our Media Services business to Deluxe Media Services for gross proceeds of \$5.6 million cash, including an estimate of net working capital, plus assumption of certain leases and other obligations. On July 30, 2003 we completed the sale of the assets of our Desktop Software business to SP Acquisition Company, for \$19.0 million cash and assumption of certain trade payables, accrued liabilities and capital leases associated with the Desktop Software business. We have accounted for the sale of both businesses as discontinued operations in accordance with SFAS No. 144 "Accounting for the Impairment and Disposal of Long-Lived Assets." Accordingly, the results of the Media Services business and the Desktop Software business for all periods presented are included in the consolidated financial statements and MD&A as discontinued operations.

Details of the discontinued Media Services business are as follows:

(in thousands)	For the Years Ended September 30,		
	2003	2002	2001
Revenues	\$ 4,943	\$ 9,399	\$ 10,734
Cost of revenues	4,037	7,214	7,733
 Gross margin	 906	 2,185	 3,001
Operating expenses	2,816	4,959	38,634
 Operating loss	 (1,910)	 (2,774)	 (35,633)
Other income (expense)	123	(55)	(664)
 Loss from operations of the Media Services business	 \$(1,787)	 \$(2,829)	 \$(36,297)
	____	____	____

Details of discontinued Desktop Software business are as follows:

(in thousands)	For the Years Ended September 30,		
	2003	2002	2001
Revenues	\$11,950	\$15,898	\$ 15,550
Cost of revenues	1,987	2,991	5,187
 Gross margin	 9,963	 12,907	 10,363
Operating expenses	7,271	9,699	21,786
 Operating income (loss)	 2,692	 3,208	 (11,423)
Other income (expense)	(3,835)	(4,070)	(55)
 Loss from operations of the Desktop Software business	 \$(1,143)	 \$(862)	 \$(11,478)
	____	____	____

**Cumulative Effect of Changes in Accounting Principle, Amortization of Goodwill and Other Purchase Intangibles**

Effective October 2001, the Company adopted Financial Accounting Standards Board ("SFAS") No. 142, "Goodwill and Other Intangible Assets." In accordance with SFAS No. 142, the Company ceased the amortization of goodwill associated with the services reporting unit, which included the acquisitions of STV Communications and International Image. Implementation of SFAS No. 142 also required an assessment of the carrying value of goodwill using a number of criteria, including the value of the



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**For the Year Ended September 30, 2003**

overall enterprise as of October 1, 2001. The Company retained an independent appraisal firm to assist in the assessment, which resulted in a \$44.7 million write off of the entire remaining value of goodwill associated with the services reporting unit. Future impairment charges, if any, associated with MediaSite or other acquisitions will be reflected as an operating expense in the statement of operations.

## **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, 2003, 2002 and 2001, we had cash and cash equivalents of \$12.6, \$3.7 and \$7.8 million.

2003 compared to 2002

Cash used in operating activities totaled \$4.1 million in 2003 compared to \$4.9 million in 2002. Fiscal 2002 had greater outflows related to accounts payable assumed in the MediaSite transaction and fiscal 2003 reflected improved collections from accounts receivable.

Cash provided by investing activities totaled \$20.9 million in 2003 compared to a use of cash from investing activities of \$1.7 million in 2002. Investing activities for the current year included net proceeds from the sale of the Company's Media Services and Desktop Software businesses of \$4.8 and \$16.3 million, respectively.

In 2003, we recorded net cash used in financing activities of \$7.9 million compared to \$2.6 million provided by financing activities in 2002. In early 2003, we issued a bridge note of \$1.0 million to the brother of Rimas Buinevicius, Chief Executive Officer and repaid the balance in full in July 2003. In addition, we closed a line of credit with a bank in Canada and paid the \$451 thousand balance. We also made monthly and balloon payments totaling \$7.2 million to certain convertible subordinated note holders and paid off the note holders in full in July 2003.

2002 compared to 2001

Cash used in operating activities totaled \$4.9 million in 2002 compared to \$10.2 million in 2001. The change related to a \$6.7 million improvement in operating expenses, excluding 2001 restructuring charges, amortization, and write-off of prepaid Internet advertising. This improvement was offset slightly by payment of liabilities assumed in the MediaSite transaction.

Cash used in investing activities totaled \$1.7 million in 2002 compared to \$2.0 million in 2001. Investing activities in both years relate to fixed asset and acquisition related outflows. 2001 also included \$1.2 million of proceeds from the sale of underutilized assets.

In 2002, net cash provided by financing activities was \$2.6 million compared to net cash used in 2001 financing activities of \$2.0 million. The most significant occurrences of 2002 were \$6.5 million of net proceeds from subordinated debt and \$2.4 million of payments to settle the remaining \$3.3 million of notes (plus accrued interest) related to the International Image acquisition. The settlement also included 500 thousand shares of stock valued at \$660 thousand. The difference between the principal and accrued interest balance and the settlement cost was recorded as a gain, net of certain legal and settlement costs. In addition, in 2002, we also incurred \$248 thousand of debt related to a one-time deferred compensation plan.

### **Recent Developments Impacting Liquidity**

The Company determined in the fall of 2002 that operations of our Desktop Software and Media Services businesses, along with our existing cash reserves, would not provide sufficient cash to fund planned growth of the systems division and make remaining subordinated debt payments. In response, the Company retained an advisor to evaluate the sale of certain operating assets and in May 2003, completed the sale of the Media Services business for approximately \$5.6 million cash, including an estimate of \$1.1 million for net working capital. In July 2003, we completed the sale of the Desktop Software business for \$19.0 million cash, certain other consideration and assumption of certain trade payables, accrued liabilities and capital leases. Proceeds of the transactions were used to retire all outstanding indebtedness including convertible subordinated notes and a bridge loan.

The Company expects the proceeds of the asset sale transactions noted above to provide sufficient liquidity to fund operations for at least the next twelve months.

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**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.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Report of Ernst & Young LLP, Independent Auditors

The Board of Directors and Stockholders Sonic Foundry, Inc.

We have audited the accompanying consolidated balance sheets of Sonic Foundry, Inc. (the Company) as of September 30, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended September 30, 2003. Our audits also included the financial statement schedule listed in the index at Item 16(a). 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 audits.

We conducted our audits in accordance with auditing standards generally accepted in the 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 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 at September 30, 2003 and 2002 and the consolidated results of its operations and its cash flows for each of the three years in the period ended September 30, 2003, in conformity with accounting principles generally accepted in the United States. 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.

As discussed in Note 12 to the financial statements, effective October 1, 2001, the Company changed its method of accounting for goodwill.

**ERNST & YOUNG LLP**

Milwaukee, Wisconsin  
November 14, 2003

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

	September 30,	
	2003	2002
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 12,623	\$ 3,704
Accounts receivable, net of allowances of \$40 and \$50	508	484
Accounts receivable, other	139	43
Inventories	111	48
Prepaid expenses and other current assets	214	294
Current assets of discontinued operations	—	4,087
 Total current assets	 13,595	 8,660
Property and equipment:		
Leasehold improvements	132	—
Computer equipment	741	768
Furniture and fixtures	96	96
 Total property and equipment	 969	 864
Less accumulated depreciation	381	290
 Net property and equipment	 588	 574
Other assets:		
Goodwill and other intangible assets, net	7,726	7,776
Capitalized software development costs, net of amortization of \$508 and \$227	892	1,173
Debt issuance costs, net of amortization of \$323	—	653
Long-term assets of discontinued operations	—	8,807
 Total other assets	 8,618	 18,409
 Total assets	 \$ 22,801	 \$ 27,643
 <b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 1,065	\$ 1,531
Accrued liabilities	1,263	950
Unearned revenue	194	—
Convertible debt, net of discount	—	3,482
Current portion of capital lease obligations	48	217
Current liabilities of discontinued operations	—	2,976
 Total current liabilities	 2,570	 9,156
Long-term obligations, net of current portion	—	230
Capital lease obligations, net of current portion	—	38
Long-term liabilities of discontinued operations	—	235
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, \$.01 par value, authorized 100,000,000 shares; 28,684,449 and 27,729,825 shares issued and 28,614,199 and 27,702,075 shares outstanding	287	277
Additional paid-in capital	168,106	167,028
Accumulated deficit	(147,532)	(148,985)
Receivable for common stock issued	(462)	(26)
Cumulative foreign currency translation adjustments	—	(111)

Unearned compensation	—	(49)
Treasury stock, at cost, 70,250 and 27,750 shares	(168)	(150)
Total stockholders' equity	20,231	17,984
<b>Total liabilities and stockholders' equity</b>	<b>\$ 22,801</b>	<b>\$ 27,643</b>
	<b>_____</b>	<b>_____</b>

See accompanying notes

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

	Years Ended September 30,		
	2003	2002	2001
<b>Continuing Operations</b>			
<b>Revenue:</b>			
Product sales	\$ 1,172	\$ 206	\$ —
Customer support fees	84	12	—
Other	8	641	—
	<hr/>	<hr/>	<hr/>
Total revenue	1,264	859	—
Cost of revenue	888	380	—
	<hr/>	<hr/>	<hr/>
<b>Gross margin</b>	376	479	—
<b>Operating expenses:</b>			
Selling and marketing expenses	2,975	2,548	—
General and administrative expenses	3,189	2,728	2,624
Product development expenses	1,742	3,079	—
	<hr/>	<hr/>	<hr/>
Total operating expense	7,906	8,355	2,624
	<hr/>	<hr/>	<hr/>
<b>Loss from operations</b>	(7,530)	(7,876)	(2,624)
<b>Other income (expense):</b>			
Interest expense	—	(13)	—
Other income (expense), net	(19)	(425)	539
	<hr/>	<hr/>	<hr/>
Total other income (expense)	(19)	(438)	539
	<hr/>	<hr/>	<hr/>
<b>Loss from continuing operations</b>	(7,549)	(8,314)	(2,085)
Loss from operations of discontinued operations including \$68 of income tax benefit in 2003 and \$12 of income tax expense in 2002	(2,930)	(3,691)	(47,775)
Gain on disposal of discontinued operations	11,932	—	—
	<hr/>	<hr/>	<hr/>
<b>Income (loss) before cumulative effect of change in accounting principle</b>	1,453	(12,005)	(49,860)
Cumulative effect of change in accounting principle	—	(44,732)	—
	<hr/>	<hr/>	<hr/>
<b>Net income (loss)</b>	\$ 1,453	\$(56,737)	\$(49,860)
	<hr/>	<hr/>	<hr/>
<b>Income (loss) per common share:</b>			
Continuing operations	\$ (0.27)	\$ (0.31)	\$ (0.09)
Discontinued operations	0.32	(0.14)	(2.16)
Cumulative effect of change in accounting principle	—	(1.67)	—
	<hr/>	<hr/>	<hr/>
Basic net income (loss) per common share	\$ 0.05	\$ (2.12)	\$ (2.25)
	<hr/>	<hr/>	<hr/>
Diluted net income (loss) per common share	\$ 0.05	\$ (2.12)	\$ (2.25)
	<hr/>	<hr/>	<hr/>

See accompanying notes

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**Sonic Foundry, Inc.**  
**Consolidated Statements of Stockholders' Equity**  
**For the Years Ended September 30, 2003, 2002 and 2001**  
(in thousands)

	Common stock	Common stock to be issued	Additional Paid-in Capital	Accumulated deficit	Currency translations	Receivables for common stock issued	Unearned compensation	Treasury stock	Total
<b>Balance, September 30, 2000</b>	\$ 219	\$ 5,579	\$ 148,290	\$ (42,388)	\$ 137	\$ (72)	\$ (1,249)	\$ (150)	\$ 110,366
Issuance of common stock	2	—	214	—	—	—	—	—	216
Issuance of common stock warrants and options	—	—	635	—	—	—	(616)	—	19
Exercise of common stock warrants and options	2	—	99	—	—	4	—	—	105
Conversion of exchangeable stock to common stock	—	(204)	204	—	—	—	—	—	—
Amortization of unearned compensation and adjustments related to employee terminations	—	—	(1,249)	—	—	—	1,735	—	486
Recission of option exercise and subsequent reissuance	—	—	(5)	—	—	34	—	—	29
Comprehensive loss:									
Net loss	—	—	—	(49,860)	—	—	—	—	(49,860)
Foreign currency translation adjustments	—	—	—	—	(130)	—	—	—	(130)
Comprehensive loss	—	—	—	(49,860)	(130)	—	—	—	(49,990)
<b>Balance, September 30, 2001</b>	\$ 223	\$ 5,375	\$ 148,188	\$ (92,248)	\$ 7	\$ (34)	\$ (130)	\$ (150)	\$ 61,231
Issuance of common stock	6	—	808	—	—	—	—	—	814
Issuance of common stock warrants with convertible debt	—	—	6,707	—	—	—	—	—	6,707
Issuance of common stock warrants and options	—	—	205	—	—	—	(98)	—	107
Issuance of common stock, stock options and stock warrants for acquisitions	42	—	5,640	—	—	—	—	—	5,682
Exercise of common stock warrants and options	1	—	110	—	—	8	—	—	119
Conversion of exchangeable stock to common stock	5	(5,375)	5,370	—	—	—	—	—	—
Amortization of unearned compensation	—	—	—	—	—	—	179	—	179
Comprehensive loss:									
Net loss	—	—	—	(56,737)	—	—	—	—	(56,737)
Foreign currency translation adjustments	—	—	—	—	(118)	—	—	—	(118)
Comprehensive loss	—	—	—	(56,737)	(118)	—	—	—	(56,855)
<b>Balance, September 30, 2002</b>	\$ 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				1,453	111				1,564
<b>Balance, September 30, 2003</b>	<b>\$ 287</b>	<b>\$ —</b>	<b>\$ 168,106</b>	<b>\$ (147,532)</b>	<b>\$ —</b>	<b>\$ (462)</b>	<b>\$ —</b>	<b>\$ (168)</b>	<b>\$ 20,231</b>

See accompanying notes

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

	Years Ended September 30,		
	2003	2002	2001
<b>Operating activities</b>			
Net income (loss)	\$ 1,453	\$(56,737)	\$(49,860)
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Gain on disposal of discontinued operations	(11,932)	—	—
Cumulative effect of change in accounting principle	—	44,732	—
Amortization of goodwill, other intangibles, and capitalized software development costs	406	417	27,923
Depreciation and amortization of property and equipment	2,220	3,614	3,726
Amortization of debt discount and debt issuance costs	2,978	3,409	—
Non-cash compensation charges and charges for stock warrants and options	228	291	635
Non-cash advertising charge	—	—	1,000
Loss on sale of assets	98	535	2,576
Write-off of long-term investment	—	514	—
Gain on settlement of debt	—	(238)	—
Changes in operating assets and liabilities:			
Accounts receivable	819	79	5,444
Inventories	(46)	756	788
Prepaid expenses and other assets	164	462	431
Accounts payable and accrued liabilities	(472)	(2,717)	(2,860)
Total adjustments	(5,537)	51,854	39,663
Net cash used in operating activities	(4,084)	(4,883)	(10,197)
<b>Investing activities</b>			
Proceeds from sale of discontinued operations, net	21,093	—	—
Acquisitions, net of cash acquired	—	(579)	(1,255)
Purchases of property and equipment	(250)	(1,131)	(1,984)
Proceeds from disposals of assets	15	17	1,216
Net cash provided by (used in) investing activities	20,858	(1,693)	(2,023)
<b>Financing activities</b>			
Proceeds from issuance of common stock, net of issuance costs	438	263	317
Proceeds from debt issuances	1,069	6,783	436
Payments on long-term debt and capital leases	(8,941)	(4,332)	(3,349)
Proceeds from (payments on) line of credit, net	(451)	(119)	571
Net cash provided by (used in) financing activities	(7,885)	2,595	(2,025)
Effect of exchange rate changes on cash	30	(124)	106
Net increase (decrease) in cash	8,919	(4,105)	(14,139)
Cash and cash equivalents at beginning of period	3,704	7,809	21,948
Cash and cash equivalents at end of period	\$ 12,623	\$ 3,704	\$ 7,809
Supplemental cash flow information:			
Interest paid	\$ 1,004	\$ 493	\$ 321
Income taxes paid (refunded)	(362)	259	—
Noncash transactions:			
Capital lease acquisitions	33	32	100
Issuance of options for deferred compensation plan	—	98	—

Conversion of exchangeable stock into common stock	—	5,375	204
Common stock and stock options issued for MediaSite	—	5,016	—
Common stock issued for Digital Savant	—	541	—
Common stock issued for liabilities assumed in MediaSite transaction	—	125	—
Common stock issued for debt settlement	—	660	—
Reclassification of goodwill to fixed assets upon final appraisal of International Image	—	—	1,281
Reduction of goodwill upon settlement of notes due certain International Image	—	—	—
Shareholders	—	—	200
Cancellation of unvested stock options classified as unearned compensation upon acquisition of STV	—	—	1,249
Issuance of warrants for consulting services	224	49	19

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**1. Basis of Presentation and Significant Accounting Policies**

***Business and Concentration of Credit Risk***

Sonic Foundry, Inc. (the Company) is in the business of developing automated rich-media application software and systems, (our "Media Systems" business). Our current operations were formed in October 2001 when we acquired the assets and assumed certain liabilities of MediaSite, Inc. ("MediaSite"). See Note 11.

Until recently, we were engaged in three businesses – Media Services, Desktop Software and Media Systems. Our media services operation ("Media Services") was a mature business that was a result of several acquisitions the Company made over recent years. 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).

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. The Desktop Software business included a number of mature products such as Sound Forge, ACID and Vegas. 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.

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") and previously reported consolidated financial statements have been restated to reflect the discontinued operations presentation. See Note 2 – Management's Plan and 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.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the accompanying financial statements and notes. 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 has not accepted product returns, other than for limited 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

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currently represents sales of our MediaSite Live ("MSL") product, excluding the revenue generated from service-related solutions, which is included in services revenue discussed below.

**Services**

We sell support contracts to customers of our MSL hardware, 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 as well as an extension of the standard hardware warranty from 90 days to one year. Hardware warranty service is performed by the manufacturer we contract with to build the units. 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 MediaSite Publisher and custom software development performed under time and materials or fixed fee arrangements. 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 include fees recorded pursuant to long-term contracts, using the percentage of completion method of accounting, when significant customization or modification of a product is required.

**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.

**Shipping and Handling**

Costs related to shipping and handling are included in cost of sales for all periods presented.

**Concentration of Credit Risk**

All domestic and international sales are denominated in either U.S. or Canadian dollars. The Company performs periodic credit evaluations of its customers' financial condition and generally does not require collateral. We maintain allowances for potential credit losses and such losses have been within our expectations. Sales to our largest customer in 2003 comprised 10% of total sales. Sales to our two largest customers in 2002 comprised 29% and 25% of total sales.

**Cash and Cash Equivalents**

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

**Inventory Valuation**

Inventory of completed MSL 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,	
	2003	2002
Raw materials and supplies	\$ 52	\$ 48
Finished goods	59	—
	<hr/>	<hr/>
	\$111	\$ 48
	<hr/>	<hr/>



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### **Software Development Costs**

In 2002, the Company capitalized \$1.4 million of software development related to the MediaSite transaction (see note 11). 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, 2003 and 2002 are net of accumulated amortization of \$407 and \$127 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:

	<b>Years</b>
Leasehold improvements	5 to 10 years
Computer equipment	3 to 5 years
Furniture and fixtures	7 years

### **Impairment of Long-Lived Assets**

Property and equipment, capitalized software development costs and goodwill and other intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. 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.

### **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. 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.

### **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 Company has no debt instruments outstanding at September 30, 2003.

### **Stock Based Compensation**

As permitted by SFAS No. 123, "Accounting for Stock-Based Compensation," the Company follows Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," 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, 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):

	<b>Years Ended September 30,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
(in thousands)			
Net income (loss) as reported	\$1,453	\$(56,737)	\$(49,860)
Less stock-based compensation using fair value method	(279)	(3,241)	(2,707)
Less impact of discounted employee stock purchase plan using fair value method	(26)	(77)	(124)
Pro forma net income (loss)	\$1,148	\$(60,055)	\$(52,691)
Pro forma net income (loss) per share – basic and diluted	\$ 0.04	\$ (2.24)	\$ (2.38)

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Pro forma information regarding net income (loss) and net income (loss) per share and 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 1.38 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,		
	2003	2002	2001
Denominator for basic earnings per share			
— weighted average common shares	27,794,000	26,812,000	22,129,000
Effect of dilutive options and warrants (treasury method)	581,000	—	—
Denominator for dilutive earnings per share			
— adjusted weighted average common shares	28,375,000	26,812,000	22,129,000
Securities outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive:			
Options and warrants	5,748,000	8,885,000	4,020,000

**Recent Accounting Pronouncements**

In July 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" (SFAS 146), which addresses financial accounting and reporting associated with exit or disposal activities. Under SFAS 146, the Company measures costs associated with an exit or disposal activity at fair value and recognize the costs in the period in which the liability is incurred rather than at the date of a commitment to an exit or disposal plan. The Company adopted SFAS 146 on October 1, 2002.

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees", Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 provides guidance on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued and also clarifies that a guarantor is required to recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantee. The Company adopted FIN 45 in fiscal 2003.

In November 2002, the EITF reached a consensus on Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables" (EITF 00-21). EITF 00-21 establishes criteria to determine whether an arrangement that contains multiple deliverables should be divided into separate units of accounting and how the arrangement consideration should be allocated among the separate units. EITF 00-21 was effective for arrangements entered into after June 30, 2003.

In January 2003, the FASB issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46). FIN 46 requires a company to consolidate any variable interest entities for which the company has a controlling financial interest. FIN 46 also requires disclosures about the variable interest entities that the Company is not required to consolidate, but in which it has a significant variable interest. The Company adopted the consolidation requirements of FIN 46 on February 1, 2003.

The adoption of SFAS 146, FIN 45, EITF 00-21 and FIN 46 had no effect on the Company's financial position, results of operations or stockholders' equity.

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## 2. Management's Plan and Discontinued Operations

In the fall of 2002, the Company determined that operations of our Desktop Software and Media Services businesses, along with our existing cash reserves, would not provide sufficient cash flow to fund planned growth of the systems division and make remaining subordinated debt payments. In response, the Company retained an advisor to evaluate the sale of certain operating assets.

### 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 a final determination of actual working capital. The Company received \$350 thousand of the remainder in September 2003 and expects to receive a final payment of at least \$76 thousand in 2004. The Company recorded a loss on disposition of the Media Services business of \$2.0 million. The book value of assets sold and liabilities assumed of the discontinued Media Services business as of September 30, 2002 was as follows (in thousands):

	September 30, 2002
Current assets	\$ 2,097
Property and equipment, net	6,089
Other assets, including goodwill of \$479	638
 Total assets	 \$ 8,824
 Total liabilities	 \$ 2,085

Details of the discontinued Media Services business are as follows (in thousands):

	For the Years Ended September 30,		
	2003	2002	2001
Revenues	\$ 4,943	\$ 9,399	\$ 10,734
Cost of revenues	4,037	7,214	7,733
 Gross margin	 906	 2,185	 3,001
Operating expenses	2,816	4,959	38,634
 Operating loss	 (1,910)	 (2,774)	 (35,633)
Other income (expense)	123	(55)	(664)
 Loss from operations	 \$(1,787)	 \$(2,829)	 \$(36,297)

### Desktop Software

The Company entered into an amended and restated asset purchase agreement with 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 is payable to Sony Pictures Digital. The Company recorded a gain on the disposal of the Desktop Software business in the fourth fiscal quarter of \$13.9 million. The book value of assets sold and liabilities assumed of the discontinued Desktop Software business as of September 30, 2002 was as follows (in thousands):

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	September 30, 2002
Current assets	\$ 1,990
Property and equipment, net	2,034
Other assets	46
<b>Total assets</b>	<b>\$ 4,070</b>
<b>Total liabilities</b>	<b>\$ 1,126</b>

Details of the discontinued Desktop Software business are as follows (in thousands):

	For the Years Ended September 30,		
	2003	2002	2001
Revenues	\$11,950	\$15,898	\$ 15,550
Cost of revenues	1,987	2,991	5,187
<b>Gross margin</b>	<b>9,963</b>	<b>12,907</b>	<b>10,363</b>
Operating expenses	7,271	9,699	21,786
<b>Operating income (loss)</b>	<b>2,692</b>	<b>3,208</b>	<b>(11,423)</b>
Other income (expense)	(3,835)	(4,070)	(55)
<b>Loss from operations</b>	<b>\$ (1,143)</b>	<b>\$ (862)</b>	<b>\$ (11,478)</b>

### 3. Long-Term Investment and Other Assets

In June 2002, the Company wrote off the balance of its \$514 thousand investment in a company that developed high speed networking products for broadband access based on an evaluation of qualitative and quantitative factors including discussions with management of the Company and review of financial information and other materials.

### 4. Long-Term Debt and Notes Payable

#### *Convertible Debt (paid in 2003)*

In January and February 2002, the Company completed a \$7.1 million offering of convertible subordinated debt with several lenders. The promissory notes ("Notes") bore interest at 10% per annum, payable quarterly, and required the Company to repay principal (if not converted) in monthly installments of \$330 thousand commencing August 1, 2002 with a final installment in the aggregate amount of \$1.2 million due on the maturity date of February 1, 2004.

In December 2002, the Company reached an agreement with lenders totaling \$4.75 million of original principal of the Notes to modify the original repayment terms. In return, the Company agreed to provide the lenders with a second collateral position in all the assets of the Company and to increase the rate of interest to 12% per annum, payable quarterly.

The Notes were convertible into shares of our common stock, in whole or in part, at any time. The conversion price was \$2.45 per share, subject to potential anti-dilution adjustments. The lenders also received 1.2 million warrants to purchase shares of common stock at an exercise price of \$2.94. In April 2003, the Company agreed to reduce the exercise price of 776 thousand warrants issued to two of the lenders to \$0.36 in return for certain concessions on repayment terms. The Company used the Black-Scholes option pricing model to determine the increase in value of the warrants before and after the exercise price reduction. The analysis concluded that there was an immaterial change in values assuming a risk-free interest rate of 3%, dividend yield of 0%, expected common stock market price volatility factor of 1.5. Accordingly, no adjustment was recorded for the reduction in exercise price.

The Company also paid the placement agents \$502 thousand in commissions and issued them 154 thousand warrants to purchase common stock at an exercise price of \$2.94. The commissions and fair value of the warrants were accounted for as debt issuance costs.

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The warrants granted to the lenders and the placement agents expire in February 2006.

The initial value allocated to the warrants issued was measured at the date of grant because the number of shares was fixed and determinable. The value was determined based upon a Black-Scholes option pricing model with the following assumptions: risk-free interest rate of 3%, dividend yield of 0%, expected common stock market price volatility factor of 1.5 and the expected life of the warrants. The valuation of the lenders warrants reduced the carrying value of the debt by \$2.8 million and was recorded as a debt discount. The debt discount recorded for the warrant valuation caused a beneficial embedded conversion feature valued at \$3.5 million, which was recorded as an additional debt discount.

The debt discount was amortized using an effective interest method over the two-year term of the debt. Payment of the remaining balance of the Notes and accrued interest, including a pre-payment premium of \$475 thousand was a closing requirement of the Desktop Software business transaction, and accordingly, was paid in full at close of the sale on July 30, 2003. Interest, amortization of debt discount, pre-payment premium and loss on early extinguishment of debt are included in discontinued operations.

*Bridge Note (paid in 2003)*

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 secured by substantially all the assets of the Company and was due upon completion of the sale of the Desktop Software business. Payment of the note, including accrued interest of \$296 thousand, was a closing requirement of the Desktop Software business transaction and, accordingly, was paid in full at close of the sale on July 30, 2003. Interest is included in discontinued operations.

## 5. Commitments

Assets under capital leases are no longer utilized, and accordingly, the Company wrote off the remaining book value of capital leases and accumulated amortization at September 30, 2003. 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 \$533, \$280, and \$0 thousand for the years ended September 30, 2003, 2002 and 2001, respectively. The following is a schedule by year of future minimum lease payments under capital and operating leases, excluding the anticipated receipt of sublease income of \$13 and \$40 thousand in 2004 and 2005 respectively.

Fiscal Year (in thousands)	Capital	Operating
2004	\$ 48	\$ 287
2005	—	190
2006	—	134
2007	—	138
2008	—	142
Thereafter	—	—
Total	48	\$ 891
Less amount representing interest	—	—
Capital lease obligations	\$ 48	—

## 6. 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 2003 was \$0.42.

Exercise Prices	Warrants Outstanding at September 30, 2003	Expiration Date
\$ 0.09	4,426	2005
0.36 to 0.50	1,215,511	2006 to 2008

1.01 to 1.64	447,500	2006 to 2007
2.50 to 2.94	541,759	2006 to 2007
4.00 to 37.44	450,300	2004 to 2010
<hr/>		<hr/>
2,659,496		<hr/>

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## 7. Stock Options and Employee Stock Purchase Plan

The Company maintains an employee stock option plan under which the Company may grant options to acquire up to 4.0 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.

The Company also has a directors' stock option plan under which the Company may grant options to acquire up to 600 thousand shares of common stock 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, 2000	1,633,109	77,841	420,000
Amendment to increase shares available in plan	—	400,000	—
Options granted	(2,032,900)	(210,000)	(60,000)
Options forfeited	693,451	111,000	—
Shares available for grant at September 30, 2001	293,660	378,841	360,000
Amendment to increase shares available in plan	—	3,000,000	—
Options granted	(361,100)	(3,186,736)	(60,000)
Options forfeited	273,560	86,674	—
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

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

	Years Ended September 30,					
	2003		2002		2001	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of Year	6,137,234	\$ 2.45	2,974,314	\$ 3.88	1,720,469	\$ 9.25
Granted	904,000	0.55	3,607,836	1.30	2,302,900	1.27
Exercised	(766,932)	1.13	(84,682)	1.32	(244,604)	0.41
Forfeited	(1,204,224)	2.21	(360,234)	3.03	(804,451)	8.95
Outstanding at end of year	5,070,078	\$ 2.37	6,137,234	\$ 2.45	2,974,314	\$ 3.88
Exercisable at end of year	4,025,033		3,742,181		1,021,785	
Weighted average fair value of options granted during period	\$ 0.44		\$ 0.96		\$ 1.04	



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The options outstanding at September 30, 2003 have been segregated into four ranges for additional disclosure as follows:

	Options Outstanding			Options Exercisable	
	Options Outstanding at September 30, 2003	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Options Exercisable at September 30, 2003	Weighted Average Exercise Price
<b>Exercise Prices</b>					
\$0.42 to \$0.74	781,968	9.37	\$ 0.43	48,634	\$ 0.57
\$1.01 to \$1.75	3,266,678	7.88	1.14	3,042,758	1.14
\$2.00 to \$2.62	468,991	6.31	2.31	383,655	2.35
\$3.13 to \$5.03	277,676	5.51	3.99	277,676	3.99
<b>\$5.91 to \$59.88</b>	<b>274,765</b>	<b>6.35</b>	<b>21.01</b>	<b>272,310</b>	<b>21.09</b>

The Company maintains an Employee Stock Purchase Plan (Stock Purchase Plan), which allows for the issuance of 1.0 million shares of common stock. There were 150, 115 and 181 thousand shares issued under the plan for the years ended September 30, 2003, 2002 and 2001, respectively. All employees of the Company who have completed three months of employment are 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 may be 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.

## 8. Income Taxes

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

	Years Ended September 30,		
	2003	2002	2001
Federal income tax	\$ —	\$ —	\$ —
Canadian income tax (benefit)	(68)	12	—
Deferred income tax benefit	1,135	(4,032)	(8,503)
Change in valuation allowance	(1,135)	4,032	8,503
<b>Income tax expense (benefit)</b>	<b>\$ (68)</b>	<b>\$ 12</b>	<b>\$ —</b>

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,		
	2003	2002	2001
Income tax expense (benefit) at U.S. statutory rate of 34%	\$ 494	\$(19,291)	\$(16,952)
Permanent differences, net	(99)	15,354	8,577
Adjustment of temporary differences to income tax returns	554	—	—
Other	186	(95)	(128)
Canadian income tax expense (benefit)	(68)	12	—
Change in valuation allowance	(1,135)	4,032	—
<b>Income tax expense (benefit)</b>	<b>\$ (68)</b>	<b>\$ 12</b>	<b>\$ —</b>

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

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	September 30,	
	2003	2002
Deferred tax assets:		
Net operating loss and other carryforwards	\$ 22,863	\$ 23,537
Common stock warrants	738	649
Allowance for doubtful accounts	16	284
Other	14	11
	<hr/>	<hr/>
Total deferred tax assets	23,631	24,481
Valuation allowance	(23,346)	(24,481)
Deferred tax liability-depreciation of property and equipment	(43)	(116)
Deferred tax liability-amortization of goodwill, other intangible assets and capitalized software development costs	(242)	—
	<hr/>	<hr/>
Net deferred tax liabilities	\$ —	\$ (116)
	<hr/>	<hr/>

At September 30, 2003, the Company had net operating loss carry forwards of approximately \$57 million for U.S. Federal and state tax purposes, which expire in varying amounts between 2011 and 2022. In the event of a change in ownership greater than 50% in a three-year period, utilization of the net operating losses may be subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986 and similar state provisions.

## **9. 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 \$207, \$291 and \$286 thousand during the years ended September 30, 2003, 2002 and 2001, respectively.

## **10. Related-Party Transactions**

The Company incurred fees of \$427, \$192 and \$214 thousand during the years ended September 30, 2003, 2002, and 2001, respectively, to a law firm whose partner is a director and stockholder of the Company.

During the years ended September 30, 2003, 2002 and 2001, the Company had loans outstanding to certain executives totaling \$25, \$58 and \$25 thousand, respectively. The largest outstanding balance was \$25 thousand. In all cases, the loans were 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.

## **11. Acquisitions**

On October 15, 2001, the Company completed the asset purchase of MediaSite, which provides automated rich media publishing, management and access solutions. Under terms of the purchase agreement, a wholly-owned subsidiary of the Company purchased the majority of the assets of MediaSite and assumed certain of its liabilities in exchange for 3.9 million shares of the Company's common stock and 300 thousand warrants valued at \$1.20 per share. Also as part of the purchase, the Company capitalized \$490 thousand in closing costs, \$3.1 million in assumed liabilities and a \$365 thousand advance that was issued to MediaSite in September 2001. The acquisition was accounted for as a purchase, and accordingly, the results of operations were included in the consolidated financial statements from the purchase date.

Approximately \$9.1 million of intangible assets resulted from the purchase of MediaSite. The Company obtained an independent appraisal, which resulted in an allocation of \$120 thousand to a license agreement, \$130 thousand to the MediaSite trade name and \$1.4 million to acquired technology (software development costs). All three were determined to have useful



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lives of 5 years and are being amortized to cost of goods sold. The remaining balance of \$7.5 million was assigned to goodwill and, in accordance with SFAS No. 142, is not amortized, but is reviewed annually for impairment, (see Note 12).

On February 12, 2002 the Media Services business purchased all the intellectual property rights to Media Taxi™ from Los Angeles based Digital Savant, Inc. in exchange for \$100 thousand and 221 thousand shares of the Company's common stock. The acquisition was accounted for as a purchase. Media Taxi is a widely deployed browser-based media asset management system focused on streamlining the management and distribution of marketing and publicity materials for the entertainment industry and included in the sale of the Media Services business to Deluxe Media Services in May 2003.

## **12. Goodwill and Other Intangible Assets**

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets", which established financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets." The Company early adopted SFAS No. 142 on October 1, 2001, the beginning of its fiscal year. 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. Accordingly, the Company reclassified the net book value of assembled workforce to goodwill and ceased amortization of all goodwill, on October 1, 2001.

In the year of adoption, the standard required a transitional goodwill impairment evaluation be performed, which was a two-step process. The first step was a screen for whether there was an indication that goodwill was impaired as of October 1, 2001. At such time, the Company had two reporting units – software and services. The entire goodwill balance, which had resulted from the 2000 acquisitions of STV Communications and International Image, related to the services unit. To determine if the goodwill was impaired, the Company retained an independent appraisal firm to perform a valuation of the services unit using the criteria prescribed under SFAS 142. During December 2001, the appraisal firm completed this first step, which indicated that goodwill recorded during the 2000 acquisitions mentioned above was impaired as of October 1, 2001.

For the second step, the Company used the services of the same independent appraisal firm to compare the implied fair value of the affected reporting unit's goodwill to its carrying value in order to measure the amount of impairment. The fair value of goodwill was determined by allocating the reporting unit's fair value to all of its assets and liabilities in a manner similar to a purchase price allocation in accordance with SFAS No. 141, "Business Combinations." During December 2001, the appraisal firm concluded that goodwill was 100% impaired. Therefore, the Company recorded an impairment loss of \$44.7 million as a cumulative effect of a change in accounting principle in its statement of operations, for the year ended September 30, 2002.

The circumstances leading to the goodwill impairment related to: 1) the decreased demand for digital services such as encoding (especially from dot coms); 2) significant reductions of STV's workforce; 3) the Company's decreased market capitalization; and 4) a history of cash flow and operating losses for the services unit. These negative trends provided evidence that initial growth expectations of STV Communications and International Image did not materialize. The fair value used to determine the impairment was based on a combination of discounted cash flow valuation techniques, market transactions and the prices of publicly traded comparable companies.

As of July 1, 2003 an independent appraisal firm determined that goodwill recognized in connection with the acquisition of MediaSite 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. Had the Company been accounting for its goodwill under SFAS No. 142 for all periods presented, the Company's net loss and loss per share would have been as follows (in thousands except per share data):

	Year Ended September 30,	
	2002	2001
Reported net loss	\$ (56,737)	\$ (49,860)
Add back goodwill amortization	—	27,478
Proforma net loss	\$ (56,737)	\$ (22,382)
Basic and diluted – net loss per share		
Reported net loss per share	\$ (2.12)	\$ (2.25)
Goodwill amortization	—	1.24
Proforma net loss per share	\$ (2.12)	\$ (1.01)



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The following tables present details of the Company's total intangible assets:

	Life (Years)	Gross	Accumulated Amortization	Net
<b>Amortizable:</b>				
License Agreement	5	\$ 120	\$ 48	\$ 72
Trade Name	5	130	52	78
		250	100	150
Non-amortizable goodwill		7,576	—	7,576
Total		\$7,826	\$ 100	\$7,726

### 13. Restructuring and Other Charges

In December 2000, as a result of rapidly changing market conditions, the Company's Board of Directors authorized management to make a 40% workforce reduction affecting all divisions of the Company in order to reduce future cash expenditures. The restructuring charges were determined based upon plans submitted by the Company's management and approved by the Board of Directors using information available at the time. As a result of the workforce reduction, the Company exited four leased facilities and disposed of fixed assets (mainly computer equipment and trade show assets) that were no longer necessary for future operations. Future lease obligations of facilities exited were accrued net of estimated sub-lease income to be generated through the lease term. Computer equipment and trade show assets no longer necessary for operations were written down from a carrying amount of \$3.1 million to their anticipated net realizable value. As a result of the workforce reductions, termination of leases and disposal of fixed assets, the Company recorded restructuring charges of \$3.8 million during the first quarter of fiscal 2001. In September 2001, the Company refined the net realizable value of equipment no longer necessary in operations identified in the restructuring plan, and recorded an additional charge of \$1.2 million. All remaining payments related to the restructuring plan were made during 2003.

(in thousands)	Serverance and Related Charges	Lease Terminations	Fixed Asset Disposals	Other	Total
Charge in December 2000	\$ 1,470	\$ 1,555	\$ 594	\$ 163	\$ 3,782
Charge in September 2001	—	—	1,191	—	1,191
Total Charges (included in discontinued operations)	1,470	1,555	1,785	163	4,973
Adjustments to December 2000 charge	—	(503)	503	—	—
Amount paid in fiscal 2001, net	(1,470)	(707)	—	(2)	(2,179)
Non-cash charges	—	—	(2,288)	(161)	(2,449)
Accrued liabilities at September 30, 2001	—	345	—	—	345
Adjustments to December 2000 charge	—	(61)	121	—	60
Amount paid in fiscal 2002, net	—	(191)	—	—	(191)
Non-cash charges	—	—	(121)	—	(121)
Accrued liabilities at September 30, 2002	—	93	—	—	93
Amount paid in fiscal 2003, net	—	(93)	—	—	(93)
Accrued liabilities at September 30, 2003	\$ —	\$ —	\$ —	\$ —	\$ —

### 14. Quarterly Financial Data (unaudited)

The following table sets forth selected quarterly financial and stock price information for the years ended September 30, 2003 and 2002. The operating results are not necessarily indicative of results for any future period. Certain reclassifications have been made to the consolidated statement of operations for the three and nine-month periods ended June 30, 2003 in connection with the Company's presentation of discontinued desktop software operations. Such reclassifications affect the amount of research and development costs and debt extinguishment costs included in discontinued desktop software operations versus continuing



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operations; and decrease the loss from continuing operations (and correspondingly increase the loss from discontinued desktop software operations) by \$294 and \$839 thousand for the quarter and nine months ended June 30, 2003, respectively,. The reclassification had no impact the Company's previously reported net loss.

(in thousands)	Quarterly Financial Data							
	Q4-2003	Q3-2003	Q2-2003	Q1-2003	Q4-2002	Q3-2002	Q2-2002	Q1-2002
Revenues	\$ 530	\$ 343	\$ 218	\$ 173	\$ 141	\$ 175	\$ 405	\$ 138
Gross margin	180	148	32	16	15	80	282	102
Loss from continuing operations	(2,119)	(1,803)	(1,516)	(2,092)	(2,512)	(2,050)	(1,704)	(1,610)
Net income (loss)	11,422	(4,517)	(2,105)	(3,347)	(3,971)	(2,504)	(2,912)	(47,350)
Basic and diluted net income (loss) per share	\$ 0.41	\$ (0.16)	\$ (0.08)	\$ (0.12)	\$ (0.14)	\$ (0.09)	\$ (0.11)	\$ (1.84)

Reconciliation of quarterly financial data to reported results in Form 10-Q (in thousands):

	Nine Months Ended 6/30/2003
	Q3-2003
Loss from operations reported in 10-Q	\$(2,097)
Reclassification of research and development costs to discontinued desktop software operations	272
Reclassification of debt extinguishment costs to discontinued desktop software operations	22
Adjusted loss from operations	\$(1,803)

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

**FINANCIAL**

*Not applicable.*

**PART III**

**ITEMS 10,11., 12. and 13.**

A definitive proxy statement pursuant to Regulation 14A will be filed with the Commission not later than January 28, 2004, which is 120 days after the close of the Registrant's fiscal year. The proxy statement will be incorporated by reference into Part III (Items 10 through 13) of Form 10-K.

**ITEM 14. Controls And Procedures**

**Evaluation of Disclosure Controls and Procedures**

Based on evaluations as of a date within 90 days of the filing date of 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-14 (c) and 15d-14 (c) under the Securities Exchange Act) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

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**Changes in Internal Controls**

There were no significant changes in our internal controls or in other factors that could significantly affect these internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

**ITEM 15. Principal Accountant Fees and Services**

A definitive proxy statement pursuant to Regulation 14A will be filed with the Commission not later than January 28, 2004, which is 120 days after the close of the Registrant's fiscal year. The proxy statement will be incorporated by reference into Part III (Items 14) of Form 10-K.

**PART IV**

**ITEM 16. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K**

- (a) The following financial statements are filed as part of this report:
1. Financial Statements furnished are listed in the Table of Contents provided in response to Item 8.
  2. Financial Statement Schedule. Financial Statement Schedule II of the Company is included in this Report. All other Financial Statement Schedules have been omitted since they are either not required, not applicable or the information is otherwise included in the financial statements.
  3. Exhibits.
    - 3.1 Amended and Restated Articles of Incorporation of the Registrant, filed as Exhibit No. 3.1 to the registration statement on amendment No. 2 to Form SB-2 dated April 3, 1998 (Reg. No. 333-46005) (the "Registration Statement"), and hereby incorporated by reference.
    - 3.2 Amended and Restated By-Laws of the Registrant, filed as Exhibit No. 3.2 to the Registration Statement, and hereby incorporated by reference.
    - 10.1\* Registrant's 1995 Stock Option Plan, as amended, filed as Exhibit No. 4.1 to the Registration Statement on Form S-8 on September 8, 2000, and hereby incorporated by reference.
    - 10.2\* Registrant's Non-Employee Directors' Stock Option Plan, filed as Exhibit No. 10.2 to the Registration Statement, and hereby incorporated by reference.
    - 10.3\* Employment Agreement between Registrant and Rimas Buinevicius dated as of January 1, 2001, filed as Exhibit 10.4 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2001, and hereby incorporated by reference.
    - 10.4\* Employment Agreement between Registrant and Monty R. Schmidt dated as of January 1, 2001, filed as Exhibit 10.5 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2001, and hereby incorporated by reference.
    - 10.5 Commercial Lease between Ewart Associates, L.P. and Sonic Foundry Systems Group, Inc. (now known as Sonic Foundry Media Systems, Inc.), regarding 925 Liberty Avenue, Pittsburgh, PA 15222, dated November 30, 2001, filed as Exhibit No. 10.23 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2002, and hereby incorporated by reference.
    - 10.6 Commercial Lease between Stonewood East and Sonic Foundry Media Systems, Inc. regarding 12300 Perry Highway, Wexford, PA, dated January 13, 2002 filed as Exhibit No. 10.24 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2002, and hereby incorporated by reference.

**Sonic Foundry, Inc.**  
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- 10.7 Asset Purchase Agreement dated February 6, 2002 by and among Sonic Foundry Media Services, Inc. and Digital Savant, Inc., filed as Exhibit No. 10.26 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2002, and hereby incorporated by reference.
- 10.8\* Registrant's 2001 Deferred Compensation Plan, filed as Exhibit 4.4 to Form S-8 on November 21, 2001 and hereby incorporated by reference.
- 10.9 Stock Restriction and Registration Agreement between Sonic Foundry, Inc., Zero Stage Capital VI Limited Partnership, Saturn Capital, Inc. and Saturn Partners Limited Partnership dated October 15, 2001 filed as Exhibit 4.4 to Form S-3 filed on December 21, 2001, and hereby incorporated by reference.
- 10.10\* Registrant's Amended 1999 Non-Qualified Plan, filed as Exhibit 4.1 to Form S-8 on December 21, 2001, and hereby incorporated by reference.
- 10.11 Software License and Marketing Agreement effective as of March 25, 2002 between Registrant and Broderbund Properties LLC filed as Exhibit No. 99.2 to the Registration Statement on Form S-3 filed on August 13, 2002 and hereby incorporated by reference.
- 10.12 Amended and Restated License Agreement effective October 15, 2001 between Carnegie Mellon University and MediaSite, Inc. filed as Exhibit No. 10.31 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 , and hereby incorporated by reference.
- 10.13 Warrant Agreement filed as Exhibit 10.1 to Registration Statement No. 333-98795 on Form S-3 filed on August 27, 2002 and hereby incorporated by reference.
- 10.14 Promissory Note between Registrant and Aris A. Buinevicius and Claire Horne for \$1,250,000 dated November 18, 2002 filed as Exhibit No. 10-27 to the Quarterly Report on Form 10-Q for the quarter ended December 31, 2002, and hereby incorporated by reference.
- 10.15 Amendment No. 1 to the Purchase Agreement dated February 11, 2002 by and between Sonic Foundry, Inc. and Omicron Partners, L.P, filed as exhibit 2.1 to the registration statement on Form S-3 filed on April 29, 2002, and hereby incorporated by reference.
- 10.16 Note—Exhibit A to Amendment No. 1 to the Purchase Agreement, filed as exhibit 2.2 to the registration statement on Form S-3 filed on April 29, 2002, and hereby incorporated by reference.
- 10.17 Warrant—Exhibit B to Amendment No. 1 to the Purchase Agreement, filed as exhibit 2.3 to the registration statement on Form S-3 filed on April 29, 2002, and hereby incorporated by reference.
- 10.18 Registration Rights Agreement—Exhibit C to Amendment No. 1 to the Purchase Agreement, filed as exhibit 2.4 to the registration statement on Form S-3 filed on April 29, 2002, and hereby incorporated by reference.
- 10.19 Asset Purchase Agreement among Deluxe Media Services, Inc. the Registrant, Sonic Foundry Media Services, Inc. and International Image Services, Inc., dated April 30, 2003 filed as Exhibit 99.2 to Form 8-K filed on May 21, 2003, and hereby incorporated by reference.
- 10.20 Amended and Restated Asset Purchase Agreement, incorporated by reference from Appendix A of Schedule 14A filed on June 19, 2003 and hereby incorporated by reference.

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- 10.21 Commercial Lease between West Washington Associates LLC and Sonic Foundry, Inc. regarding 222 West Washington Blvd., Madison, WI, dated August 1, 2003 filed herewith.
  - 21 List of Subsidiaries
  - 23 Consent of Ernst & Young LLP, Independent Auditors
  - 31.1 Section 302 Certification of Chief Executive Officer
  - 31.2 Section 302 Certification of Chief Financial Officer
  - 32 Section 906 Certification of Chief Executive Officer and Chief Financial Officer
    - \* Compensatory Plan or Arrangement
- (b) REPORTS ON FORM 8-K
- (1) On August 7, 2003, Registrant filed a report dated July 30, 2003 on Items 2 and 7 of Form 8-K with respect to the sale of the Company's Desktop Software Business to SP Software Acquisition Company, a wholly-owned subsidiary of Sony Pictures Digital, Inc., a Delaware corporation, pursuant to that certain Amended and Restated Asset Purchase Agreement, dated as of June 6, 2003 and effective as of May 2, 2003 by and between Sonic Foundry and SP Software Acquisition Company. No financial statement were filed with this report.
  - (2) On August 22, 2003, Registrant filed a report dated August 15, 2003 on Item 9 of Form 8-K with respect to third quarter and nine month financial results. No financial statements were filed with this report.

**Sonic Foundry, Inc.**  
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**SIGNATURES**

Pursuant to the requirement of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized in the City of Madison, State of Wisconsin, on December 22, 2003.

**Sonic Foundry, Inc.**  
**(Registrant)**

By: /s/ Rimas P. Buinevicius

Rimas P. Buinevicius  
Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities and on the dates indicated.

<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ Rimas P. Buinevicius	Chairman and Chief Executive Officer	December 22, 2003
/s/ Monty R. Schmidt	Chief Technology Officer and Director	December 22, 2003
/s/ Kenneth A. Minor	Chief Financial Officer and Secretary	December 22, 2003
/s/ Frederick H. Kopko, Jr.	Director	December 22, 2003
/s/ Arnold Pollard	Director	December 22, 2003
/s/ David C. Kleinman	Director	December 22, 2003

**Sonic Foundry, Inc.**  
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**SONIC FOUNDRY, INC**

**SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS**  
(In thousands)

	Balance at Beginning of Period	Additions	Deductions	Balance at End of Period
		Charged to Costs and Expenses	Write-offs	
<b><u>Year ended September 30, 2003</u></b>				
Accounts receivable reserve	\$ 50	\$ 98	\$ 108(1)	\$ 40
<b><u>Year ended September 30, 2002</u></b>				
Accounts receivable reserve	\$ —	\$ 50	\$ —	\$ 50
<b><u>Year ended September 30, 2001</u></b>				
Accounts receivable reserve	NA	NA	NA	NA

(1) Represents customer accounts receivable written off as not collectible

LEASE AGREEMENT

BETWEEN

WEST WASHINGTON ASSOCIATES LLC

AND

SONIC FOUNDRY

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# LEASE AGREEMENT

THIS LEASE, made and entered into at Madison, Wisconsin as of this \_\_\_\_\_ day of \_\_\_\_\_, 2003, is by and between West Washington Associates LLC, a Wisconsin limited liability company ("Landlord"), and Sonic Foundry, Inc., a Maryland corporation ("Tenant").

## **ARTICLE 0. BASIC LEASE PROVISIONS:**

The following descriptions and amounts are qualified by their usage elsewhere in this Lease, including without limitation those Sections referred to in parentheses following such descriptions.

### **SECTION 0.01 NAME/ADDRESS OF BUILDING:**

(Article II, Section 2.1)

Network222  
222 West Washington Avenue  
Madison, WI 53703

### **SECTION 0.02 SUITE NUMBER (if applicable):**

(Article II, Section 2.1)

Suite 775

### **SECTION 0.03 APPROXIMATE AREA:**

(Article II, Section 2.1)

Usable Area: 6,625 square feet usable

### **SECTION 0.04 (a) COMMENCEMENT DATE:**

(Article II, Section 2.2)

October 1, 2003

### **SECTION 0.04 (b) TERM OF LEASE:**

(Article II, Section 2.2)

Five (5) Lease Years, subject to two (2), three (3) year options to extend pursuant to Section 18.18.

### **SECTION 0.05 BASE RENT:**

(Article IV, Section 4.1)

\$ 10,489.58 per month  
\$ 125,875.00 per year

### **SECTION 0.06 MINIMUM ANNUAL ESCALATION:**

(Article IV, Section 4.2)

Three (3%) Percent

### **SECTION 0.07 LANDLORD'S SHARE OF OPERATING COSTS:**

(Article IV, Section 4.3)

Tenant shall pay Tenant's Pro Rata Share of increases in Operating Costs over Landlord's Share in the Base Year, as set forth in Section 4.3 herein.

### **SECTION 0.08 SECURITY DEPOSIT:**

(Article V, Section 5.1)

None

### **SECTION 0.09 BUSINESS USE:**

(Article VIII, Section 8.1)

Offices for conducting commercial business; and for no other purpose without the prior written consent of Landlord, not to be unreasonably withheld, conditioned or delayed.

### **SECTION 0.10 NOTICE ADDRESSES:**

LANDLORD: West Washington Associates LLC  
c/o The Fiore Companies, Inc.  
150 East Gilman Street  
Madison, Wisconsin 53703

TENANT: Sonic Foundry, Inc.  
222 West Washington Avenue  
Suite 775  
Madison, WI 53703

## **ARTICLE I. DEFINITIONS**

In addition to the definitions and terms set forth elsewhere throughout the Lease, the following terms will have the respective meanings set forth below:

(a) Intentionally Omitted.

(b) Base Year. The term "Base Year" means calendar year 2004.

(c) Intentionally Omitted.

(d) Building. The term "Building" will collectively refer to the office building described in Section 0.01 and associated Building Facilities, the real property on which it is situated (the legal description of which is attached hereto as Exhibit "A-1"), and any landscaping, parking facilities or structures appurtenant thereto.

(e) Building Facilities. The term "Building Facilities" means and includes all equipment, machinery, facilities and other personal property located in the Building and/or used or utilized wholly or partially in or in connection with the operation and/or maintenance of the Building, or any part thereof, whether or not located in the Building.

(f) Common Areas. The "Common Areas" consist of the entrance foyer and lobbies, corridors, elevator foyers, restrooms, mechanical rooms, telephone closets, janitor closets and other similar facilities provided for the common use and/or benefit of tenants generally and/or the public, and other areas appurtenant to or servicing the Building, including without limitation public entrance doors, stairways, passages, stairs, restrooms, and, if the Premises include less than an entire floor of the Building, the common lobbies, hallways, and toilets, and other common facilities of such floor, elevators, shipping and receiving areas, parking areas, sidewalks, plazas and landscaped areas located within, adjacent to, or near and associated with the Building.

(g) Commencement Date. The term "Commencement Date" means (a) the date specified in Section 0.04(a) provided that Premises are "ready for occupancy" as hereinafter defined; or (b) the date on which Tenant takes possession of the Premises, whichever occurs first, as adjusted under Section 3.2.

(h) Environmental Laws. The term "Environmental Laws" means any federal, state, and local law, statute, ordinance, regulation, rule, guideline, judicial decision, judicial or administrative order or decree, permit, license, approval, authorization, or similar requirement of any federal, state or local governmental agency or other governmental authority, pertaining to the protection of human health, safety, or the environment.

(i) Escalation Date. The term "Escalation Date" means the first day of the second Lease Year and on the first day of each Lease Year thereafter.

(j) Expiration Date. The term "Expiration Date" means the last day of the last consecutive full Lease Year.

(k) Intentionally Omitted.

(l) Fringe Benefits. The term "fringe benefits" includes, without limitation, the employer's contribution of F.I.C.A., unemployment compensation and other employment taxes; pension and/or profit sharing or similar plan contributions; sick, vacation and holiday pay; training costs; paid leave; worker's compensation, group life and accident and health insurance premiums; disability and other similar benefits; all paid or payable by the employer with respect to its employees.

(m) Hazardous Material(s). The term "Hazardous Material(s)" means any chemical, substance, material, object, condition or waste, or combination thereof, which (i) is defined as a hazardous substance, hazardous material, hazardous waste, pollutant, toxic material, or contaminant under any Environmental Law; (ii) is a petroleum hydrocarbon, including crude oil or any fraction thereof; (iii) may be hazardous to human health or safety or the environment due to its harmful or potentially harmful properties or effects, including toxicity, corrosivity, flammability, explosivity, infectiousness, radioactivity, carcinogenicity, or reproductive toxicity; or (iv) is regulated pursuant to any Environmental Law.

(n) Intentionally Omitted.

(o) Lease Year. The term "Lease Year" means a period of 12 consecutive full calendar months. The first Lease Year will begin on the Commencement Date if said date will occur on the first day of a month; if not, the first Lease Year will commence upon the first day of the month next following the Commencement Date of the term hereof. Each succeeding Lease Year will commence upon the anniversary of the first Lease Year.

(p) Management Company Fees. The term "Management Company Fees" means the reasonable and customary fees for management services provided by an independent management company, or reasonable fees for such services charged by Landlord or affiliated management companies (which fees shall not exceed the fees that would have been charged in an arms-length transaction.

(q) Operating Costs. The term "Operating Costs" means all reasonable and customary costs, expenses and disbursements of every kind and nature paid or incurred by the Landlord, or otherwise on behalf of the Landlord, in connection with the ownership, operation, management, maintenance, replacement and repair of the Building, all of which will be determined by Landlord on an accrual basis and in accordance with generally accepted accounting principles, consistently applied year to year. Operating Costs will include, without limiting the generality of the foregoing, the following:

1. Compensation (including fringe benefits) of all persons who perform duties in connection with the Building (including, without limitation, independent contractors, leased employees and/or temporary employees);
2. All materials, supplies, tools and equipment used in connection with the Building;
3. Electricity, fuel and other sources of power, heating and cooling; water and sewer charges; refuse collection; telephone; and similar utilities services (excluding any such cost billed to specific tenants and excluding such costs incurred by Tenant through direct metering of the Premises);
4. Maintenance and service agreements for the Building and the equipment therein, including, but not limited to, security services or alarm services, if any, window cleaning, janitorial service, HVAC maintenance, and elevator maintenance; and all such other expenses and costs necessary or desirable to be incurred for the operation, cleaning and maintenance of the Building;
5. Personal property taxes; Depreciation of equipment used in operating, cleaning and maintaining the Common Areas and/or rent paid for leasing such equipment;
6. Insurance maintained by Landlord in connection with the Building;
7. Legal, accounting, inspection, consulting and other professional services pertaining to the Building;
8. Amortization of capital costs or expenditures incurred for any repair or replacement to the Building (including any capital expenditure reasonably necessary for the operation and maintenance of the Building, made for the purpose of saving labor or otherwise reducing applicable Operating Costs, or required by law or any governmental authority), together with interest thereon at the rate of ten percent (10%) per annum, based upon the reasonable life of said expenditures determined by Landlord in accordance with generally accepted accounting principles. For purposes of determining the Operating Costs of the Building, no single expenditure of Five Thousand Dollars (\$5,000) or less will be considered capital in nature;
9. Management Company Fees;
10. All costs relating to the management office, and all other administrative expenses related to the Building;
11. All costs to Landlord of providing the services described in Sections 6.1 or 7.1;
12. Real Estate Taxes; and
13. Any other expense or charge which in accordance with generally accepted accounting and management principles consistently applied from year to year would be considered an expense of leasing, owning, maintaining or repairing the Building.

Notwithstanding the foregoing, Operating Costs will not include (i) the costs of special services rendered to tenants (including Tenant) for which a special or separate charge is made, (ii) any cost of preparation or alteration of space for other tenants in the Building, (iii) leasing costs such as advertising, promotion and marketing of space availability, legal fees associated with lease negotiations, leasing commissions, or inducements (including tenant improvement allowance, free rent, moving allowance, and lease buy-outs) granted for the purpose of securing new leases or renewals of existing leases, (iv) depreciation (except amortization of capital expenditures which are allocated over the useful life of said expenditures as described in this Section), (v) any cost of capital improvements that enlarge or expand the existing Building (except any such expenditures required by law or by any governmental or quasi-governmental authority having jurisdiction over the Building),

(vi) repairs paid by proceeds of insurance (except the deductible and that portion not covered by insurance), (vii) ground rental payments, (viii) interest payments, (ix) debt service payments made to a mortgagee, (x) financing or refinancing costs, (xi) management and administrative costs associated exclusively with the ownership structure, (xii) legal fees pertaining to lease disputes, or (xiii) any amounts payable by Landlord by way of indemnification or which constitute a fine, interest or penalty, (xiv) repairs necessitated by the negligence of the Landlord or required to cure violations of laws in effect as of the Commencement Date, (xv) any cost representing an amount paid for services or materials to a person, firm or entity related to Landlord if such amount exceeds the amount that would have been paid at market rates to a third party, (xvi) compensation paid to members, officers or executives of Landlord other than the fairly allocable compensation paid to an officer of an entity related to Landlord with respect to such officer's ordinary and necessary building management services provided to the Property.

(r) Real Estate Taxes. The term "Real Estate Taxes" will include any and all real estate taxes and assessments, ad valorem charges, special benefit assessments or charges, and all other governmental or public charges or impositions of every kind and nature whatsoever, both general and special, extraordinary as well as ordinary, foreseen and unforeseen, which may be levied, assessed or imposed upon the land, building and/or improvements located upon the tax parcel or parcels of which the Building and the Premises are a part, during any year or partial year during the term of this Lease, or on the rents received from the Building in the nature of a capital levy, and all expenses and fees, including attorneys' fees, incurred by Landlord in contesting, appealing and/or negotiating with public authorities as to any of the above.

(s) Rentable Area. The term "Rentable Area" means the rentable square footage area determined by multiplying Usable Area by 1.15 or the rentable square footage area determined in accordance with the American National Standard Method for Measuring Floor Area in Office Buildings, ANSI Z65.1-1996, published by the Building Owners and Managers Association International (hereinafter, "BOMA") whichever is less.

(t) Repair. The term "repair" will include replacement or renewal when necessary, and all such "repairs" will be made by a qualified contractor and will be equal in quality and class to the original work.

(u) Tenant's Pro Rata Share. "Tenant's Pro Rata Share" shall mean four and zero tenths (4.0%) percent, which number represents a fraction (expressed as a percentage), the numerator of which is the Usable Area of the Premises and the denominator of which is the Usable Area of the Building, which numbers are herein stipulated by both parties for all purposes under this Lease. Any change in Tenant's occupancy, whether by amendment or through the exercise of any options to expand shall change the pro rata share percentage and will be deemed in effect on the first day of the succeeding month following such change in occupancy.

(v) Usable Area. The term "Usable Area" means the usable square footage area determined in accordance with BOMA.

## **ARTICLE II. PREMISES AND TERM**

**SECTION 2.1 PREMISES.** The Landlord does hereby lease to Tenant, and Tenant hereby takes from Landlord, that certain part of the Building, hereinafter designated as the "Premises", which are more particularly described in Sections 0.02 and 0.03, and located substantially as shown in Exhibit A, reserving however to Landlord the exclusive use of the exterior walls. Tenant shall have the right, exercisable within ninety (90) days after Landlord gives Tenant written notice of the final measurements of the Premises, to remeasure the Premises according to BOMA within such ninety (90) day period. In the event that subsequent remeasurement of the Premises by Tenant, within the time period specified above, indicates that the square footage measurement prepared by Landlord produces a square footage number in excess of or lower than the square footage number which resulted from Tenant's remeasurement, any payments due to Landlord from Tenant based upon the amount of square feet contained in the Premises shall be proportionately and prospectively reduced or increased, as appropriate, to reflect the actual number of square feet as properly remeasured.

**SECTION 2.2 TERM.** The term of this Lease and Tenant's obligation to pay rent hereunder will commence upon the Commencement Date. The term of this Lease will be for the number of Lease Years set forth in Section 0.04(b). The term hereof will expire at 12:00 o'clock midnight, local time on the Expiration Date. Upon Landlord's request, the parties agree to execute an Addendum to certify the Commencement Date and Expiration Date hereof, but this Lease will not be affected in any manner if either party fails or refuses to execute such Addendum.

**SECTION 2.3 COMMON AREAS.** Landlord also grants Tenant the right under this Lease to use, in common with Landlord and other tenants, occupants and visitors to the Building, and all others to whom Landlord may grant rights thereto, the Common Areas, provided however that all such use by Tenant will be subject to such reasonable Rules and Regulations as Landlord may from time to time adopt and that Tenant may not use the Common Areas for advertising or promotional purposes. Landlord reserves the right to increase, reduce or change the size, height, layout, or location of the Building and its Common Areas (as long as Tenant's use of and access to the Premises and parking are not materially impaired). No easement, license or other right to light, air, or view is created by this Lease. The Premises do not include, and Tenant is given no right to use, control or occupy, the exterior surfaces of the Building, the roof of the Building or the airspace or plenum between the finished hung ceilings (or finished floors) in the Premises and the unfinished slab of the ceiling above (or the unfinished floor below). All space in or adjacent to the Premises used for shafts, stacks, pipes, conduits, fan rooms, ducts, utility lines, sinks, and other Building facilities, and access thereto through the Premises, is reserved to Landlord, provided such access does not unreasonably interfere with Tenant's use of and access to the Premises and parking.

**SECTION 2.4 ACCESSES TO PREMISES.** Landlord and its authorized representatives will have the right to enter the Premises at reasonable hours and, except in cases of emergency, upon reasonable advance notice to Tenant (which notice, notwithstanding any other provision of this Lease, may be given orally) to make inspections, to exhibit the Premises to prospective tenants, purchasers, or others, or to make alterations or repairs to the Building or the Premises for which it is responsible or which it is entitled to make hereunder. Notwithstanding anything to the contrary contained herein, unless Landlord obtains prior approval from Tenant, Landlord hereby agrees not to show the Premises to any prospective tenants earlier than one hundred twenty (120) days prior to the Expiration Date, as extended. In the event of emergency or in order to comply with any laws, orders, ordinances or requirements of any governmental unit or authority (regarding which compliance is the responsibility of Landlord), Landlord and its authorized representatives will have the right of entry at any time and may perform any acts related to safety, protection, preservation or improvement of the Building or the Premises or required by such governmental unit or authority. The proper exercise by Landlord of any of its rights under this provision will not be deemed an eviction or disturbance of Tenant's use and possession of the Premises and Tenant will not be entitled to an abatement or reduction in rental by reason of any such action.

### **ARTICLE III. CONSTRUCTION AND INSTALLATIONS**

**SECTION 3.1 LANDLORD'S WORK.** Landlord shall, at its own cost and expense, perform the work and make the installations to the Premises that are set forth as Landlord's Work in Exhibit B. Tenant acknowledges that neither Landlord nor any agent, employee or representative of Landlord has made any representation or warranty with respect to the suitability of the Building or Premises for the conduct of Tenant's business or any other purpose. Landlord will have the right, at its election, at any time and from time to time, to make such alterations or changes in portions of the Building outside the Premises as it may deem necessary or desirable so long as such alterations or changes do not unreasonably interfere with the use and occupancy by Tenant of the Premises and parking or Tenant's access to the Premises or parking.

**SECTION 3.2 READY FOR OCCUPANCY.** The Premises will be deemed to be "ready for occupancy" under the terms of this Lease if Landlord's construction or remodeling of the Premises as required by Section 3.1 is complete except for punchlist items that do not interfere with Tenant's use or enjoyment of the Premises ("Substantial Completion" or "Substantially Complete"). In the event a dispute occurs as to whether or not Landlord's construction or remodeling of the Premises is Substantially Complete, the certification of Landlord's architect or engineer that Landlord's construction of the Premises is Substantially Complete in accordance with the requirements herein and in Exhibit B will be deemed final and conclusive. The taking of possession by Tenant of the Premises for the conduct of Tenant's normal business operations will be deemed conclusive that Tenant accepted delivery of the Premises as Substantially Complete, subject to the punchlist items described above (which Landlord shall complete within a reasonable time not to exceed thirty (30) days after the Commencement Date). If Tenant has taken possession of the Premises as Substantially Complete, Landlord agrees that it will diligently carry forward its construction of the Premises to final completion in accordance with its obligations as required by Section 3.1 and 3.2. The term "Tenant Delay" shall mean any actual delay of Landlord in completing Landlord's Work specified in Exhibit B as a result of a Tenant's failure

to timely approve the Final Plans (such timeframes set forth in Exhibit B); or b) any Change Order; or c) the performance and/or completion of any Tenant Work by a person, firm or corporation employed by Tenant. In the event a Tenant Delay, the Commencement Date of this Lease and the payment of rent thereunder will be accelerated by the number of days of such Tenant Delay. Notwithstanding anything in the Lease to the contrary, if the Commencement Date has not occurred (other than by reason of Tenant Delay) on or before sixty (60) days after the date of this Lease, then Landlord shall incur the following financial penalties which shall be credited to Tenant's Base Rent as it becomes due and payable: a) \$250.00 per day for days 61 through 75; b) \$500 per day for days 76 through 90; and \$1,000 per day for every day beyond the 90<sup>th</sup> day of this Lease. If the Commencement Date has not occurred on or before the 90<sup>th</sup> day after the date of this Lease (other than by reason of Tenant Delay), Tenant shall have the right, at its option, to terminate this Lease by sending written notice of such election to Landlord. Every day of Tenant Delay shall extend the above time frames on a day-for-day basis. An election by Tenant to terminate this Lease as provided for in this Section shall not limit Tenant's right to payment by Landlord of the financial penalties set forth above.

**SECTION 3.3 ALTERATIONS AND INSTALLATIONS BY TENANT.** Tenant shall have the right, at its own cost and expense, to perform the Tenant's Work described on Exhibit B for Tenant's initial occupancy in the Premises. The improvements installed in the Premises (including Landlord's Work and the Tenant's Work) in connection with the initial occupancy of Tenant shall be called the "Tenant Improvements." After construction of Tenant Improvements, Tenant will make no improvements, alterations, or additions of any kind, whether structural or non-structural (the "Alterations") in or to the Premises or the Building without first obtaining Landlord's prior written approval of Tenant's contractor, the plans, and the specifications therefor such approval not to be unreasonably withheld, conditioned, or delayed. Tenant shall acquire all necessary permits to construct the Alterations from appropriate governmental agencies, furnishing a copy thereof to Landlord prior to commencement of such construction. Tenant shall comply with all conditions of any such required permit and with all specifications in the plans in commercially reasonable manner. Tenant will not commence any such work without first delivering to Landlord certificates of insurance, evidencing that Tenant has obtained a policy or policies of commercial general liability and property damage insurance, naming Landlord as an additional insured, in limits and with companies reasonably approved by Landlord pursuant to Section 9.1. Landlord's approval of the plans, specifications and working drawings for Tenant's improvements, alterations, or additions will create no responsibility or liability on the part of Landlord for their completeness, design sufficiency, or compliance with all laws, rules and regulations of governmental agencies or authorities. All Tenant's Work and Alterations shall be done in a good and workmanlike manner, any fixtures installed by Tenant shall be of good quality and installed in a workmanlike manner.

**SECTION 3.4 DEVELOPMENT PLAN.** It is understood that Exhibit A indicates, in general, the site plan for the Building of which the Premises are a part; and a floor plan of the floor(s) on which the Premises is located; that Landlord, in building and operating the improvements may make such other departures from and changes in said plan as Landlord, in its sole discretion, may from time to time find proper, provided such changes do not unreasonably interfere with Tenant's right to use or occupy the Premises and parking or access to the Premises or parking. Landlord may, in its sole discretion, change the location of other tenants and the nature, layout or size of any occupancy of any space unit other than Premises at any time, construct additional buildings or improvements and make additions or alterations thereto, and change or vary the parking, walkways, driveways and common areas or layout thereof without the same being deemed an eviction or disturbance of Tenant and without any abatement of rent, provided such improvements and changes do not unreasonably interfere with Tenant's right to use or occupy the Premises and parking or access to the Premises or parking.

#### **ARTICLE IV. RENT AND OTHER CHARGES**

**SECTION 4.1 BASE RENT.** Tenant will, during the entire term of this Lease, pay to Landlord the annual Base Rent set forth in Section 0.05 (as such amount may be adjusted from time to time as provided in Section 4.2), in equal monthly installments payable on the Commencement Date and in advance on the first day of each calendar month thereafter during the term of this Lease, without any offset or deduction whatsoever or any prior demand. All payments of rent will be made to Landlord at its office or at such other place as it may designate in writing. If the Commencement Date is not on the first day of a month, the Base Rent for the fractional month containing the Commencement Date will be prorated on a per diem basis with respect to the fractional month, and paid to Landlord on the first day of the next month. Notwithstanding this, Base Rent shall be abated through December 31, 2003.

**SECTION 4.2 ADJUSTMENT TO BASE RENT.** Base Rent will be increased effective on the Escalation Date by the addition thereto of an amount which is the product obtained by multiplying the Minimum Annual Escalation percentage set forth in Section 0.06 by the Base Rent in effect immediately prior to the Escalation Date.

**SECTION 4.3 ADDITIONAL RENTS.** In addition to Base Rent, Tenant will pay as "Additional Rent" the sums or amounts set forth hereinafter or as become due and payable elsewhere in this Lease.

(a) Landlord agrees to expend as its share of Operating Costs during any calendar year an amount equal to the actual Operating Costs of the Building incurred during the Base Year ("Landlord's Share"). Prior to the commencement of each calendar year or as soon thereafter as possible, Landlord will provide a written estimate of the Operating Costs expected to be incurred during the calendar year in excess of Landlord's Share for the same period and showing Tenant's Pro Rata Share of such amount ("estimated Tenant's Share of Operating Costs Increases"). Commencing on the first anniversary of the Commencement Date Tenant will pay to Landlord, during the remaining Term of this Lease, the estimated Tenant's Share of Operating Costs Increases, in equal monthly installments payable in advance on the first day of each calendar month, without any offset or deduction whatsoever or any prior demand unless otherwise provided in this Lease.

(b) If Landlord will not have furnished estimated Operating Costs at the times contemplated herein, then until such estimated Operating Costs are provided, Tenant will continue to pay an amount equal to the monthly sum payable under this Section in respect of the last month of the preceding calendar year. In such event, promptly after estimated Operating Costs are furnished to Tenant, or together therewith, Landlord will give notice stating whether the aggregate amount of the installments of estimated Tenant's Share of Operating Costs Increases previously made for such calendar year is more or less than the aggregate amount of the installments of estimated Tenant's Share of Operating Costs Increases to be made for the then-current calendar year in accordance with such estimated Operating Costs, and (i) if there is a deficiency, within thirty (30) days after receipt of such notice Tenant will pay the amount of such deficiency, or (ii) if there has been an overpayment, Landlord will credit Tenant in the amount thereof toward subsequent payments of Base Rent or Additional Rent (or, upon termination of the Lease, Landlord will reimburse Tenant such overpayment in cash and within sixty (60) days thereof with Landlord's obligations under this Section surviving expiration or any earlier termination of this Lease); and (iii) on the first day of the next following month, and monthly thereafter throughout the remainder of such calendar year, Tenant will pay an amount equal to one-twelfth (1/12) of estimated Tenant's Share of Operating Costs Increases, shown on such estimated Operating Costs. Landlord may at any time or from time to time revise the estimated Operating Costs and, in such case, the estimated Tenant's Share of Operating Costs Increases for the remainder of the calendar year will be based upon such revised estimate of Operating Costs and adjusted, paid, and/or credited, as applicable, substantially in the same manner as provided above.

(c) Within one hundred twenty (120) days after the end of each calendar year, or at such later time as Landlord will be able to determine the actual amounts of Operating Costs, Landlord will furnish to Tenant a written statement ("Landlord's Statement") showing the actual Operating Costs for the calendar year, Landlord's Share of Operating Costs during the Base Year, and Tenant's Pro Rata Share of Operating Costs during such calendar year in excess of Landlord's Share ("actual Tenant's Share of Operating Costs Increases"). If Landlord's Statement shows that the estimated Tenant's Share of Operating Costs Increases exceeded the actual Tenant's Share for such calendar year, then Landlord will credit Tenant in the amount of such excess against subsequent payments of Base Rent and Additional Rent. If Landlord's Statement will show that the estimated Tenant's Share of Operating Costs increases were less than actual Tenant's Share of Operating Costs Increases for such period, Tenant will pay the amount of such deficiency within thirty (30) days after the delivery to Tenant of such Landlord's Statement. Landlord's failure to render a Landlord's Statement with respect to any period will not eliminate or reduce Tenant's obligation to pay actual Tenant's Share of Operating Costs Increases for such period and will not prejudice Landlord's right to render a Landlord's Statement with respect to any subsequent period. The obligations of Tenant under the provisions of this paragraph with respect to any increase in Additional Rent will survive the expiration or any sooner termination of the this Lease.

(d) In respect of any Lease Year or partial Lease Year (including the Base Year) in which the Building is not occupied to the extent of ninety-five percent (95%) of the Rentable Area thereof, the Operating Costs in respect of such period will for the purposes of this Section, be increased to be equal to the amount which would have been incurred had the Building been occupied to the extent of ninety-five percent (95%) of the Rentable Area thereof.

(e) Tenant will have the right to inspect Landlord's accounting records relative to Operating Costs of the Building at Landlord's accounting office in Madison, Wisconsin during normal business hours at any time within two (2) years following receipt of Landlord's Statement for the Base Year and within one (1) year with respect to any other calendar year. Unless Tenant takes written exception to any item within such time periods, such Landlord's Statement will be considered as final and accepted by Tenant. If Tenant makes a timely written exception to Landlord (a "Notice Dispute") and if Landlord and Tenant do not agree on the proper amount for actual Tenant's Share of Operating Costs Increases within thirty (30) days of such Notice of Dispute, the matter shall be submitted to an independent certified public accountant selected by Landlord, with reasonable approval by Tenant, whose determination shall be final. If Landlord shall have overstated Tenant's Share of Operating Costs by more than five (5) percent, Landlord shall pay all costs of such examination. If Landlord shall not have overstated Tenant's Share of Operating Expenses by more than five percent (5%), Tenant shall pay all costs of such examination.

(f) In the event that an increase in Real Estate Taxes is caused by Tenant's improvements made to the Premises, Tenant will pay when due all the increase attributable to such improvements. If the improvements, the taxes for which are to be paid separately by Tenant, are not separately assessed, Landlord will equitably determine Tenant's portion of that tax from the respective valuations assigned in the assessor's worksheets or such other information (which may include the cost of construction) as may be reasonably available. Notwithstanding anything to the contrary contained herein, Tenant shall have the right, in the name of the Landlord and with the Landlord's full cooperation, but without any cost to Landlord, to bring suit in any court of competent jurisdiction to recover the amount of any such Real Estate Taxes paid under protest on the basis of this paragraph, and any amount so recovered shall belong to Tenant; provided, however, that wherever circumstances permit, Landlord shall not pay any such Real Estate Taxes until Tenant has had a reasonable opportunity to investigate and contest such Real Estate Taxes, or post a bond in lieu of payment. Notwithstanding this, Landlord shall not be required to take any action that may result in the delinquency of Real Estate Taxes due and payable or to take any action that may result in a lien being placed on the Building.

**SECTION 4.4 UTILITIES.** Landlord shall provide utility services, including electricity and heating, ventilation and air conditioning ("HVAC") to the Premises in the manner set forth in Section 6.1. A submeter measuring the amount of electricity consumed by Tenant shall be installed and Tenant will pay Landlord (or the Electric Service Provider if directed by Landlord) for such electricity consumed. If Landlord shall bill Tenant, said payment will be calculated using the rate Tenant would pay the utility company furnishing such service if a direct meter served the Premises. Tenant will operate or draw from the heating, ventilating and air conditioning system or systems that serve the Premises and other premises in a manner not to unduly drain HVAC in violation of Section 6.1.

Landlord has advised Tenant that presently Madison Gas & Electric ("Electric Service Provider") is the utility company selected by Landlord to provide electricity service for the Building. Notwithstanding the foregoing, Landlord will have the right at any time and from time to time during the Lease Term to either contract for service from a different company or companies providing electricity service (each such company will hereinafter be referred to as an "Alternate Service Provider") or continue to contract for service from the Electric Service Provider. Tenant will cooperate with Landlord, the Electric Service Provider, and any Alternate Service Provider at all times and, as reasonably necessary, will allow Landlord, Electric Service Provider, and any Alternate Service Provider reasonable access to the Building's electric lines, feeders, risers, wiring, and any other machinery within the Premises.

Landlord shall in no way be liable or responsible for any loss, damage, or expense that Tenant may sustain or incur by reason of any change, failure, interference, disruption, or defect in the supply or character of the electric energy furnished to the Premises, or if the quantity or character of the electric energy supplied by the Electric Service Provider or any Alternate Energy Provider is no longer available or suitable for Tenant's requirements, and no such change, failure, defect, unavailability, or unsuitability shall constitute an actual or constructive eviction, in whole or in part, or entitle Tenant to any abatement or diminution of rent, or relieve Tenant from any of its obligations under this Lease. Notwithstanding the foregoing, in the event of any such failure which (i) renders the Premises untenantable, (ii) is within Landlord's control to remedy and (iii) continues uninterrupted for a period of five (5) business days, the Base Rent shall abate for the number of

days such failure continues beyond such five (5) business day period. In addition, if such failure continues for thirty (30) consecutive days, Tenant shall have the right at its option to terminate this Lease by sending Landlord written notice of such election prior to the failure having been corrected.

**SECTION 4.5 PARKING AND STORAGE.** Tenant will pay to Landlord, during the entire term of this Lease, in monthly installments payable in advance on the first day of each calendar month, without any offset or deduction whatsoever or any prior demand, except as otherwise provided herein, the amounts set forth in any Parking Addendum and/or any Storage Space Addendum incorporated in this Lease. Unless Tenant executes a Parking Addendum or Storage Space Addendum, Tenant will have no right to use any underground parking facilities or storage facilities of the Building, respectively.

**SECTION 4.6 INTEREST ON PAST DUE OBLIGATIONS.** Except as may expressly be provided in this Lease to the contrary, any amount due to Landlord not paid when due will bear interest at the rate of five percent (5%) per annum greater than the prime rate as published in the Wall Street Journal as the same may fluctuate from and after the date on which the payment was first due through the date on which the payment is paid in full, provided, however, that the payment of such interest will in no event exceed the highest rate allowed under applicable law. Payment of such interest will not excuse or cure any default by Tenant under this Lease. The exercise of this right by Landlord will not be construed to be a waiver of any default by Tenant or of any other right which Landlord may exercise under this Lease.

**SECTION 4.7 LATE CHARGES.** Tenant hereby acknowledges that late payment of rent and other sums due hereunder will cause Landlord to incur costs not contemplated by this Lease, the exact amount of which will be extremely difficult to ascertain. Such costs include, but are not limited to, processing and accounting charges, and late charges that may be imposed on Landlord by the terms of any mortgage covering the Premises. Accordingly, if any installment of Base Rent, Additional Rent or any other sum due from Tenant is not received by Landlord or Landlord's designee within five (5) days after said amount is due, then Tenant will immediately pay to Landlord a late charge equal to ten percent (10%) of such overdue amount or the sum of One Hundred Dollars (\$100.00), whichever is greater provided, however, such late charge will only be applied upon the second occurrence during the Term of the Lease (as extended). The parties hereby agree that such late charge represents a fair and reasonable estimate of the cost Landlord will incur by reason of late payment by Tenant, and is in addition to Interest on Past Due Obligations. Acceptance of such late charge by Landlord will in no event constitute a waiver of Tenant's default with respect to such overdue amount, or prevent Landlord from exercising any of the other rights and remedies granted under this Lease.

## **ARTICLE V. SECURITY DEPOSIT**

**SECTION 5.1 AMOUNT OF DEPOSIT.** Tenant will deposit with Landlord upon execution hereof the sum set forth in Section 0.08. Said deposit will be held by Landlord, with right of comminglement and use, and without liability for interest or duty to render accounting, as security for the faithful performance by Tenant of all terms, covenants and conditions of this Lease by Tenant to be kept and performed during the term hereof.

**SECTION 5.2 USE AND RETURN OF DEPOSIT.** If Tenant fails to keep and perform any of the terms, covenants and conditions of this Lease beyond any applicable cure period, then Landlord at its option may apply said deposit, or so much thereof as may be necessary to compensate Landlord for loss or damage sustained or suffered by Landlord due to such breach on the part of Tenant. Should the entire deposit, or any portion thereof, be so applied by Landlord, then Tenant will, upon Landlord's demand, forthwith remit to Landlord a sufficient sum to restore said security to the original sum deposited, and Tenant's failure to do so within ten (10) days after receipt of such demand will constitute a breach of this Lease. Should Tenant comply with all of said terms, covenants and conditions and promptly pay all of the rents herein provided for as they fall due, and all other sums payable by Tenant hereunder, said deposit will be returned in full to Tenant at the end of the term of this Lease.

**SECTION 5.3 TRANSFER OF DEPOSIT.** Landlord may transfer the security deposit to any purchaser of Landlord's interest in the Premises, and thereupon Landlord will be discharged from any further liability with respect to said deposit.

## **ARTICLE VI. SERVICES BY LANDLORD**

**SECTION 6.1 BASIC SERVICES.** Provided Tenant is not in default of its obligations under this Lease beyond any applicable cure period, Landlord agrees to furnish for the Premises the following services, consistent with the standards of a modern first-class office building, and subject to the reimbursement provisions of Section 4.3:

- (a) Heating, ventilation and air conditioning (as required by the season), at such temperatures and in such amounts as provided to similarly situated modern first class office buildings in Madison, Wisconsin and as may be reasonably required for comfortable use and occupancy under normal business operations. Whenever heat generating machines or equipment are used by Tenant in the Premises which affect the temperature otherwise maintained by the air conditioning system, as determined by Landlord, Landlord reserves the right to install supplementary air conditioning units in the Premises, and the costs therefor, including the cost of installation, operation and maintenance thereof, will be paid by Tenant to Landlord upon thirty (30) days after written demand therefor. Tenant's Premises shall contain an after hours HVAC override switch as part of Landlord's Work that will enable Tenant to heat and cool its Premises after standard business hours. (b) Electric current in reasonably sufficient amounts for normal business use, including operation of building standard lighting and general office machines of a type that are typically used in modern, first class offices, such as personal computers, facsimile machines, copiers, scanners, telephone system equipment, and the like as measured at the time of execution of this Lease ("Building Standard for Electric"). Landlord will not be liable or responsible to Tenant for any loss or damage or expense which Tenant may sustain or incur if either the quantity or character of the electric service changes for causes outside of Landlord's control.
- (c) Janitorial cleaning service and refuse removal will be furnished after normal business hours on Monday through Friday (exclusive of legal holidays). The level of janitor service will not include carpet shampooing, drapery cleaning, or cleaning, maintenance, or supplies for food facilities, special equipment areas, or locker rooms located within the Premises. If Tenant requests such services to be provided to the Premises on Saturdays, Sundays, legal holidays, or times other than as specified, or if Tenant requires a level of services in excess of those to be provided by Landlord in accordance with this Section 6.1, Tenant will pay Landlord as Additional Rent the cost of those additional services based upon actual costs incurred by Landlord in providing such services.
- (d) Window washing of all exterior windows at intervals determined solely by Landlord.
- (e) Men's and women's restrooms situated on the floor on which the Premises are located together with hot and cold or tempered water for use in said restrooms.
- (f) Cold and hot water for any restroom or lunchroom facilities installed in the Premises by Tenant.
- (g) One refrigerated drinking fountain on the floor on which the Premises are located.
- (h) Passenger elevator service in common with others.
- (i) An elevator equipped for freight usage subject to scheduling by Landlord (provided, however, Landlord will allow use of the such elevator during Tenant's move-in and move-out at times reasonably requested by Tenant).
- (j) A clean, street-level lobby, entrance way, elevator lobby, public corridor, and other public portions of the Building for use in common with others.
- (k) Building directory located in close proximity to the primary entrance of the Building listing Tenant's name and suite number and Building-standard signage at the entry to Tenant's Premises at no extra charge to Tenant.
- (l) Relamping and maintaining building standard fluorescent lighting fixtures installed in the Premises.

Unless otherwise provided above, all services shall be furnished between the hours of 7:00 a.m. and 6:00 p.m. on weekdays and from 9:00 a.m. to 1:00 p.m. on Saturdays, with the exception of legal holidays.

**SECTION 6.2 INTERRUPTIONS OF SERVICES.** If any services to be provided are suspended, interrupted, or varied by strikes, accidents, repairs, maintenance, alterations, orders from any governmental authority, or any cause beyond Landlord's control, Landlord will not be liable for any damages, direct, indirect, or consequential, or for damages for personal discomfort, illness, or inconvenience of Tenant, its employees, agents, or invitees, or for loss, damage or theft of Tenant's improvements, equipment or property, unless caused by the deliberate act or negligence of Landlord, its agents, or employees. Except as set forth herein, suspension or interruption will not result in any abatement of rent, be deemed an eviction, or relieve Tenant

of performance of Tenant's obligations under this Lease. Notwithstanding the foregoing, in the event of any such suspension or interruption which (i) renders the Premises untenable, (ii) is within Landlord's control to remedy and (iii) continues uninterrupted for a period of five (5) business days, the Base Rent shall abate for the number of days such failure continues beyond such five (5) business day period. In addition, if such suspension or interruption continues for thirty (30) consecutive days, Tenant shall have the right at its option to terminate this Lease by sending Landlord written notice of such election prior to the suspension or interruption having been corrected.

## **ARTICLE VII. INSTALLATION, REPAIRS AND MAINTENANCE OF LEASED PREMISES**

**SECTION 7.1 MAINTENANCE BY LANDLORD.** Landlord will keep and maintain in good condition and repair the structural components of the Building and the Building systems, including the roof, foundation, electrical, plumbing, HVAC, mechanical, and fire and life safety systems in the Building (with respect to utilities, up to the point of entry to the Premises), exterior windows and Common Areas, and all costs incurred by Landlord in making any such repairs or maintenance will be, to the extent permitted under the definition of Operating Costs under this Lease, reimbursable to Landlord as Operating Costs of the Building. Notwithstanding the foregoing, the cost of performing any such maintenance and repairs as may be required by reason of the acts of Tenant, its employees, agents, invitees, licensees and contractors, will be paid by Tenant, at its sole expense. When used in this paragraph, the term "repairs" will include replacements or renewals when necessary, and all such "repairs", whether made by Landlord or Tenant, will be made by a qualified contractor and will be equal in quality and class to the original work. Landlord will have no obligation to perform any act that is the obligation of Tenant or any other tenant in the Building. Other than as specifically provided in this Section, Landlord will not be obligated to make any repairs or improvements of any kind, in, upon, about or to the Premises or the Building. Tenant will, upon the discovery of any defect in or injury to the Building, or any need of repairs thereto, promptly report the same to Landlord in writing specifying such defect, injury or need of repair.

Landlord reserves the exclusive right from time to time to install, use, maintain, repair, replace and relocate pipes, ducts, conduits, cables, wires, vents and appurtenant fixtures, to and through the Premises and to alter or relocate any other facility in the Building as Landlord deems reasonably necessary or appropriate for the proper operation and maintenance of the Building (including the servicing of other tenants in the Building), and reserves the right at all times to transmit water, heat, air-conditioning, electronic signals and electric current through such pipes, ducts, conduits, cables, plumbing, vents and wires, provided the same does not unreasonably interfere with Tenant's use or occupancy of and access to the Premises or parking.

**SECTION 7.2 MAINTENANCE BY TENANT.** Subject to Landlord's maintenance and repair obligations set forth in Section 7.1, Tenant, at Tenant's expense, will keep and maintain in good order, condition and repair the improvements to the Premises and every part thereof, including, without limiting the generality of the foregoing, lighting facilities and equipment within the Premises, any intra-Building telephone and network cabling installed to exclusively serve the Premises, whether or not fully contained within the Premises, fixtures, interior walls and interior surfaces of exterior walls, ceilings, windows, doors, plate and window glass (except the exterior), moldings, floor covering, water coolers, whether installed or owned by Landlord or Tenant. Tenant will repair all damage or injury to the Building or to fixtures, appurtenances, and equipment of the Building caused by Tenant's installation or removal of its property or resulting from any acts or conduct of Tenant, its employees, contractors, agents, licensees, or invitees. In the event that Tenant fails to keep and maintain the Premises in good order, condition and repair while this Lease is in effect, and Tenant fails to make necessary maintenance and repairs as soon as commercially reasonable after notice by Landlord, then Landlord may, if the same remains uncured within thirty (30) days after written notice to Tenant, restore the Premises to such good order and condition and make such repairs without liability to Tenant for any loss or damage that may accrue to Tenant's property or business by reason thereof, and Tenant will pay Landlord upon demand as Additional Rent the cost of restoring the Premises to such order and condition (and included in such cost will be an eight (8%) percent for overhead and administration fee). Notwithstanding anything contained herein to the contrary, in the event any necessary maintenance and repair cannot be completed within thirty (30) days following Landlord's notice to Tenant, but Tenant undertakes such maintenance and repair within such thirty (30) day period and diligently pursues same to completion, Landlord shall not have the right to restore or repair the Premises as provided herein.

**SECTION 7.3 ENVIRONMENTAL PROTECTION.** Tenant covenants, represents, and warrants that Tenant's use of the Premises do not and will not involve the use, storage, generation, or disposal of Hazardous

Materials (as defined herein), and that Tenant shall not cause or permit any Hazardous Materials to be brought, used, stored, generated, or disposed on or about the Premises or Building by Tenant, its agents, employees, subtenants, assigns, contractors, subcontractors, or invitees, except ordinary janitorial and office products customarily used by tenants in connection with executive office use which products are used and stored at the Premises in the proper manner, in the usual and customary quantities, and in compliance with all laws including, without limitation, Environmental Laws. Tenant shall immediately provide Landlord with written notice (i) of any actual or suspected breach hereunder; (ii) of the presence or release of any Hazardous Materials on or about the Premises or the Building; or (iii) of its receipt of any notice from any governmental agency or third party pertaining to Hazardous Materials which may affect the Premises or the Building. The parties acknowledge that this Section will survive the termination or expiration of this Lease. If Landlord receives notice of any alleged violation of any Environmental Law having been committed or about to be committed by Tenant, Landlord may, at its option immediately exercise any or all remedies available under this Lease or at law or in equity all without giving Tenant any notice or an opportunity to cure the default (notwithstanding any notice and cure provision or other Lease provisions to the contrary).

## **ARTICLE VIII. CONDUCT OF BUSINESS**

**SECTION 8.1 BUSINESS USE.** Tenant will use the Premises solely, exclusively and for no other purpose than that defined in Section 0.09, provided that the foregoing will not be construed as a representation or guarantee by Landlord that such business may lawfully be conducted on the Premises. Tenant will not permit, or suffer the use of, the Premises for any other business or purpose without Landlord's prior written consent, which Landlord shall not unreasonably withhold, condition or delay. Tenant will not permit business to be operated in or from the Premises by any concessionaire or licensee.

Tenant will not do anything nor permit anything to be done, in or about the Premises, or keep, use, offer or sell in or from the Premises any article, which will cause the cancellation of any insurance policy or increase the rate of fire or liability insurance on the Premises or the Building, or conflict with the laws related to fire, or with the regulations of the fire department, or with any insurance policy on the Building or any part thereof, or conflict with any laws, statutes, ordinances, rules or regulations of the United States, Wisconsin, or the municipality in which the property is located. In case the rate of insurance on said Building will be increased beyond the present rate by reason of the nature of the business of Tenant or any subtenant, then Tenant agrees to reimburse Landlord for the amount of such excess insurance premiums thereby caused, at the time when such premiums will be due and payable, and such payments will be due and collected by Landlord as Additional Rent.

**SECTION 8.2 RULES AND REGULATIONS.** Tenant will faithfully observe and comply with the reasonable, non-discriminatory rules and regulations that Landlord will from time to time promulgate in accordance with this Section, including without limitation any rules and regulations attached to this Lease, which are incorporated herein by reference. Tenant's failure to keep and observe such rules and regulations will constitute a breach of the terms of this Lease in the same manner as if such rules and regulations were contained herein as covenants. Landlord reserves the right from time to time to reasonably amend, rescind, and adopt reasonable and non-discriminatory additional rules and regulations as in its reasonable judgment is necessary for the safety, protection, care and cleanliness of the Building, the operation thereof, the preservation of good order therein, and the protection and comfort of its tenants, their agents, employees and invitees, which rules when made and notice thereof given will be binding upon Tenant in like manner as if originally herein prescribed. Landlord will not be responsible to Tenant for the nonperformance of any of said rules and regulations by any other tenants or occupants.

**SECTION 8.3 ALTERNATIVE TELEPHONE OR TELECOMMUNICATIONS PROVIDER.** In the event that Tenant wishes to utilize the services of a telephone or telecommunications provider whose equipment is not servicing the Building as of the date of Tenant's execution of this Lease ("Provider"), no such Provider shall be permitted to install its lines or other equipment within the Building without first securing the prior written consent of Landlord, which consent shall not be unreasonably withheld. Unless all of the following conditions are satisfied to Landlord's reasonable satisfaction in a written agreement between Provider and Landlord or by any other means acceptable to Landlord in its reasonable judgment, it shall be reasonable for Landlord to refuse to give its consent unless:

- (a) Landlord shall incur no expense whatsoever with respect to any aspect of Provider's provision of its services, including without limitation, the costs of installation, materials, and service;

- (b) Prior to the commencement of any work in or about the Building by the Provider, the Provider shall agree to abide by such rules and regulations, job site rules, and such other requirements as reasonably determined by Landlord to be necessary to protect the interest of the Building, the tenants in the Building, and the Landlord, including without limitation, providing security in such form and amount as determined by Landlord;
- (c) Landlord reasonably determines that there is sufficient space in the Building for the placement of all of the Provider's equipment and materials;
- (d) Provider agrees to compensate Landlord the reasonable amount determined by Landlord for space used in the Building for the storage and maintenance of the Provider's equipment and for all costs that may be incurred by Landlord in arranging for access by the Provider's personnel, security for Provider's equipment, and any other such costs as Landlord may expect to incur.

The provisions of this clause may be enforced solely by the Tenant and Landlord, and are not for the benefit of any other party, specifically, without limitation, no telephone or telecommunications provider shall be deemed a third party beneficiary of the Lease.

**SECTION 8.4 GOVERNMENTAL REGULATIONS.** Under no circumstances, except as caused by Landlord's negligence or willful misconduct, will Landlord be liable to Tenant for damages or otherwise resulting from any delay or total failure by Tenant in obtaining required governmental approvals and occupancy permits as may be required for Tenant's business use. Any delay hereunder will neither void nor terminate this Lease. Tenant will, at its sole cost, observe and comply with all ordinances or laws, rules, orders, regulations and requirements of federal, state, county and municipal authorities, or any other applicable governmental authority, now in force or which may hereafter be in force, which impose any duty upon Landlord or Tenant with respect to the use, occupancy or alteration of the Premises.

**SECTION 8.5 LIENS AND OBLIGATIONS.** Tenant will not create or permit others to create any lien or obligation against Landlord by reason of making repairs or installing material, fixtures or equipment, and further agrees to hold Landlord harmless from all claims and demands by any third party in any manner connected with repairs or installations undertaken by Tenant.

**SECTION 8.6 WASTE OR NUISANCE.** Tenant will not commit or suffer to be committed any waste upon the Premises or any nuisance or other act or thing which may unreasonably disturb the quiet enjoyment of any other tenant in the Building in which the Premises are located. Landlord is not responsible to Tenant for the waste, nuisance, or disturbances caused by other tenants of Building.

#### **ARTICLE IX. INSURANCE AND INDEMNITY [NOTE: SUBJECT TO REVIEW BY RISK MANAGEMENT.]**

**SECTION 9.1 INSURANCE BY TENANT.** Tenant will, at its cost and expense, obtain and maintain at all times during the Lease Term, commercial general liability insurance with a combined personal injury and property damage limit of not less than One Million Dollars (\$1,000,000) for each occurrence and not less than Two Million Dollars (\$2,000,000) in the aggregate for this location, insuring against all liability of Tenant and its representatives arising out of and in connection with Tenant's use, maintenance or occupancy of the Premises and all areas appurtenant thereto. Landlord, and other parties designated by Landlord and having an interest in the Building, will be named as additional insured. Tenant will increase its insurance coverage as may be required from time to time if, in the reasonable opinion of Landlord or Landlord's mortgagee, the amount of public liability coverage at that time is not adequate. The limits of such insurance will not, however, limit the liability of Tenant hereunder. Tenant will furnish Landlord a certificate evidencing such insurance, prepared on the ACORD 27 form or other form reasonably acceptable to Landlord. Such policies of insurance will contain provisions or endorsements preventing their cancellation, discontinuance or alteration without at least thirty (30) days' prior written notice to Landlord. The insurance secured by Tenant will insure performance by Tenant of the indemnity provisions of this Lease to the extent of claims for bodily injury and property damage, will be considered primary and not in excess of coverage Landlord may carry, and will afford coverage after the termination of this Lease for all claims based on acts, omissions, injury or damage which occurred or arose in whole or in part during the term of this Lease. The insurance secured by Tenant will apply on a primary basis to Landlord, even if Landlord has other liability coverage. Tenant will at its expense obtain and maintain all-risks property and casualty insurance coverage, written at replacement cost value and with replacement cost endorsement, covering all Tenant's personal property in the Premises and all improvements, alterations or additions made to the Premises by Tenant, but excluding improvements

constructed by Landlord as part of Landlord's Work, which improvements shall be insured under Landlord's all-risk insurance policy. All insurance required under this section will be issued by insurance companies licensed to do business in the jurisdiction where the Building is located. Such companies will have a policyholder rating of at least "A" and be assigned a financial size category of at least "Class X" as rated in the most recent edition of "Best's Key Rating Guide." If Tenant fails to comply with the aforesaid requirements, Landlord may obtain such insurance and keep the same in force and effect and Tenant will pay Landlord the cost thereof, on demand, as Additional Rent.

**SECTION 9.2 INSURANCE BY LANDLORD.** Landlord will maintain insurance in connection with the Building, which may be a blanket policy covering other properties the cost of which may be fairly allocated to this Building, against such perils and in such amounts as Landlord may from time to time determine to be advisable or which any mortgagee or creditor of Landlord requires Landlord to carry, which shall include without limitation all-risk casualty coverage with replacement cost endorsement covering the Building and the improvements in the Premises installed as part of Landlord's Work, commercial general liability, umbrella liability, boiler and machinery coverage, and rent loss insurance. The named insured on all policies of insurance will be Landlord and, if required, any mortgagee or creditor of Landlord. The cost of all insurance maintained by Landlord will be a part of the Operating Costs for the Building. It is understood that the insurance carried by Landlord does not cover the risk of loss or damage to Tenant's personal property, equipment, improvements, fixtures or loss of income.

**SECTION 9.3 EXEMPTION OF LANDLORD FROM LIABILITY.** Tenant hereby agrees that Landlord will not be liable for any damage or loss suffered by the business of Tenant, or any damage to, or loss of, property in the Premises belonging to Tenant, its employees, agents, visitors, invitees or other persons in or about the Premises, nor will Landlord be liable for injury to the person of Tenant, or its employees, agents, visitors, invitees or other persons in or about the Premises, from any cause whatsoever, including, without limitation loss, damage or injury caused by or resulting from fire, steam, electricity, gas, water or rain, or from the breakage, leakage, obstruction or other defects of pipes, sprinklers, wires, appliances, plumbing, air conditioning or lighting fixtures, or from any other cause whatsoever, whether the said damage or injury results from conditions arising upon the Premises or Building, or from other sources or places, and regardless of whether the cause of such injury or the means of repairing the same is inaccessible to Landlord or Tenant. Landlord will not be liable for any injury or damage (including lost profits) caused by other tenants or persons in the Premises, occupants of adjacent property to the Building, or the public, or caused by operations in construction of any private, public or quasi-public work. All property of Tenant kept or stored on the Premises will be so kept or stored at the risk of Tenant only and Tenant will hold Landlord harmless from any claims arising out of damage to the same, including subrogation claims by Tenant's insurance carrier. Tenant, as a material part of the consideration to Landlord, hereby assumes all risk of damage to property or injury to persons, in, upon or about the Premises arising from any cause, and Tenant hereby waives all claims in respect thereof against Landlord. However, notwithstanding the foregoing, Landlord will not be exempt from liability resulting from its own willful misconduct or negligence.

**SECTION 9.4 COVENANT TO HOLD HARMLESS.** Tenant agrees to indemnify, defend and hold harmless Landlord against and from any and all claims except and to the extent arising from the negligence or willful misconduct of Landlord, arising from (i) the use or occupancy of the Premises by Tenant, (ii) any activity, work, or thing done, or permitted or suffered by Tenant in or about the Premises or elsewhere in the Building, (iii) any breach or default on the part of Tenant in the performance of any covenant or agreement to be performed under the terms of this Lease, or (iv) from any act of negligence of Tenant, its agents, contractors, servants, employees, subtenants, concessionaires or licensees. If any action or proceeding is brought against Landlord by reason of any such claim, Tenant, upon notice from Landlord, covenants to defend such action or proceeding by counsel reasonably satisfactory to Landlord.

Landlord agrees to indemnify, defend and hold harmless Tenant against and from any and all claims, except and to the extent arising from the negligence or willful misconduct of Tenant, arising from (i) the use or occupancy of the Common Areas by Landlord, (ii) any activity, work, or thing done, or permitted or suffered by Landlord in or about the Common Areas or elsewhere in the Building, (iii) any breach or default on the part of Landlord in the performance of any covenant or agreement to be performed under the terms of this Lease, or (iv) from any act of negligence of Landlord, its agents, contractors, servants, employees, subtenants, concessionaires or licensees. If any action or proceeding is brought against Tenant by reason of any such claim, Landlord, upon notice from Tenant, covenants to defend such action or proceeding by counsel reasonably satisfactory to Tenant.

**SECTION 9.5 WAIVER OF RECOVERY.** Landlord and Tenant do each hereby relieve and release the other and waive their entire claim of recovery for loss or damage to the Premises or Building, or loss of the use thereof, arising out of or incident to any occurrence or act to be insured against by either party under the terms of this Lease, whether or not such insurance has actually been secured, and whether loss or damage is due to the negligence of either Landlord or Tenant, their officers, agents, licensees, employees, guests, invitees, visitors, or otherwise. Tenant and Landlord will give notice to their respective insurance carriers that the foregoing mutual waiver of recovery is contained in this Lease and will obtain policies of insurance which will include a waiver by the insurer of all right of subrogation against Landlord or Tenant in connection with any loss or damage thereby insured against.

#### **ARTICLE X. DESTRUCTION OF LEASED PREMISES OR BUILDINGS**

**SECTION 10.1 TOTAL OR PARTIAL INSURED DESTRUCTION.** If the Premises are damaged by fire or other insured casualty to the extent they are rendered untenantable in part, Landlord will at its own expense to the extent of available insurance proceeds cause such damage to be repaired (including reconstruction of Landlord's Work, but not including Tenant Work and Alterations). Landlord will use commercially reasonable efforts to effect such repairs promptly and in such manner as not to unreasonably interfere with Tenant's occupancy. Within sixty (60) days of such damage, Landlord shall notify Tenant of the estimated time to repair the damage. If such time is two hundred seventy (270) days or less, this Lease shall remain in full force and effect. If such time period is greater than two hundred seventy (270) days, Tenant may, at its option within ten (10) days of receipt of such notice, terminate this lease by delivery of notice of such termination to Landlord. Notwithstanding this, if the actual time to repair the Premises continues beyond three hundred sixty (360) days after such damage or other insured casualty Tenant shall have the right to terminate this Lease upon written notice to Landlord of its election to so terminate. If such damage occurs during the last year of the term of this Lease, Landlord or Tenant will have the right to terminate this Lease upon delivery of written notice of termination to the other party within ninety (90) days after the date such damage occurred. If the Premises are rendered wholly untenantable by reason of such damage, either Landlord or Tenant may terminate this Lease as of the date of such damage by delivery of written notice of such party's election to terminate to the other party within ninety (90) days after the date such damage occurred, provided, however, if neither party has terminated this Lease, Landlord will proceed with reasonable diligence to restore the Premises as set forth above. If the Building is destroyed or damaged by fire or other casualty to the extent of one-fourth (1/4) or more of the Rentable Area, notwithstanding that the Premises may be unaffected by such fire or other casualty, and Landlord determines not to rebuild or repair said damage, then so long as Landlord terminates substantially all other tenancies in the Building, this Lease may be terminated by Landlord upon ninety (90) days' written notice and thereupon this Lease will end and Tenant will surrender possession and rent will be adjusted as of the date of such termination.

**SECTION 10.2 UNINSURED CASUALTY.** In the event the Premises are damaged to any extent by any casualty, act, or occurrence not covered by Landlord's insurance, Landlord may repair the damage, in which event this Lease will continue, or Landlord may elect not to repair the damage and to terminate this Lease upon delivery of written notice to Tenant within ninety (90) days after the date such damage occurred.

**SECTION 10.3 DAMAGE TO TENANT'S IMPROVEMENTS.** If Landlord is obligated to or elects to repair or restore as provided herein, Landlord will be obligated to make repairs or restoration only of those portions of the Building and Premises that were originally provided at Landlord's expense (including Landlord's Work but not including Tenant Improvements and Alterations). The repair and restoration of items in the Premises not provided at Landlord's expense will be the obligation of Tenant.

**SECTION 10.4 PARTIAL ABATEMENT OF RENT.** Tenant agrees that during any period of reconstruction or repair of the Premises, Tenant will continue the operation of Tenant's business within the Premises to the extent practicable. If all or any portion of the Premises are untenantable because of damage or destruction by fire or other causes not resulting from fault or negligence of Tenant, its agents, employees, contractors, or invitees, and Landlord is required or elects to repair such damage, Tenant's Base Rent will be abated to the extent the Premises are untenantable, from the date of the occurrence until repairs by Landlord are completed or until Tenant again uses the untenantable portion for the conduct of its normal business operations, whichever occurs first. However, there will be no abatement of other sums to be paid by Tenant as required by the provisions of this Lease.

**SECTION 10.5 REQUIREMENTS OF MORTGAGEE.** If Landlord's mortgagee, ground landlord or other creditors should require that insurance proceeds payable upon damage to or destruction of the Building or Premises by fire or other casualty, be used to retire or apply on the debt secured by its mortgage, ground lease or security agreement, Landlord will, in such event, have no obligation to repair or rebuild such damage. In such event, this Lease will terminate, at Landlord's election, upon delivery of written notice of termination to Tenant.

**SECTION 10.6 EXPRESS AGREEMENT.** This Lease will be considered an express agreement governing any case of damage to or destruction of the Building or the Premises by fire or other casualty. Any law presently in effect or subsequently enacted that purports to govern the rights of Landlord and Tenant will have no application.

#### **ARTICLE XI. ASSIGNMENT OR SUBLetting**

**SECTION 11.1 ASSIGNMENT OR SUBLetting.** Tenant will not assign, mortgage, pledge, sell, or in any manner transfer this Lease or any estate or interest hereunder, and will not sublet the Premises or any part or parts thereof, without express written consent of Landlord, which will not be unreasonably withheld, conditioned or delayed. This Lease, and Tenant's interest therein, will not be assignable by operation of law. Landlord's right to assign this Lease is and will remain absolute and unqualified.

Landlord will not be deemed unreasonable in the exercise of its discretion for withholding its consent to any proposed transfer under this section if (i) the occupancy resulting from such transfer will not be consistent with the general character of the business carried on by the tenants of the Building or violates any rights or options held by any other tenant of the Building; or (ii) the proposed occupant pursuant to the transfer does not have the financial strength and stability to perform its rental obligations or Landlord is unable to obtain guarantees from one or more affiliates of the proposed occupant in order to secure such financial obligations; or (iii) any proposed sublease does not incorporate this Lease in its entirety so as to be subject to this Lease's terms, or any such sublease does not require the sublease to attorn to Landlord at Landlord's option in the event of a default by Tenant under this Lease; or (iv) if Tenant does not execute an agreement with Landlord requiring Tenant to pay to Landlord, as Additional Rent, fifty percent (50%) of all moneys or other consideration received by Tenant from its transferee (whether paid to Tenant as consideration for Tenant's transfer of property or other assets to the transferee or as consideration for the transferee's occupancy of the Premises) in excess of the amounts owed by Tenant to Landlord under this Lease, which Additional Rent will be paid to Landlord as and when received by Tenant.

Notwithstanding anything contained herein to the contrary, Tenant may assign this Lease or sublet the Premises or any portion thereof, without Landlord's consent, to any parent, subsidiary or affiliate corporation which controls, is controlled by or is under common control with Tenant, or to any corporation resulting from a merger or consolidation with Tenant, or to any person or entity which acquires all or substantially all of the assets of Tenant's business as a going concern.

In the event of a permitted assignment by Tenant, Tenant will remain liable for the faithful performance of all the terms and conditions in this Lease in the event that the assignee will default in the performance of the terms and conditions, or in the payment of the rent required thereby.

**SECTION 11.2 CORPORATE OWNERSHIP.** If Tenant is a corporation and if at any time during the term of this Lease any part or all of the corporate shares of said corporation are transferred by sale, assignment, operation of law or other disposition (except transfers by gift, bequest or inheritance) so that the result of such transfer would be the loss of effective voting control of said corporation by the person or persons owning a majority of said corporate shares at the date of this Lease, Tenant will notify Landlord in writing of such changes and Landlord may terminate this Lease at any time after such change in control by giving Tenant 90 days' written prior notice of such termination. This Section, however, will not apply if on the date this Lease is executed Tenant is a corporation, the outstanding common stock of which is listed on a recognized security exchange, or if at least 80% of Tenant's stock is owned by another corporation, the common stock of which is so listed.

## **ARTICLE XII. DEFAULTS**

**SECTION 12.1 DEFAULTS.** The occurrence of any one or more of the following events will constitute an Event of Default under this Lease by Tenant:

- (a) Failure by Tenant to make any payment of rent or any other payment required to be made by Tenant hereunder, as and when due, where such failure will continue for a period of ten (10) days after written notice by Landlord.
- (b) Failure of Tenant to comply with any provision of this Lease other than payment of rent, with such failure continuing for thirty (30) days after written notice by Landlord specifying the nature of non-compliance by Tenant with reasonable particularity provided. However, if the nature of Tenant's default is such that more than thirty (30) days are reasonably required for its cure, Tenant will not be in default if Tenant promptly commences or has commenced such cure and thereafter diligently proceeds to cure such default within a period of time which, under all prevailing circumstances, will be reasonable. Furthermore, no notice of default shall be required in the case of a violation by Tenant of Sections 15.1 or 15.3.
- (c) (i) Insolvency of Tenant or the execution by Tenant of an assignment for the benefit of creditors; or (ii) Filing by or against Tenant of a petition to have Tenant adjudged bankrupt, or a petition for reorganization or arrangement under any law relating to bankruptcy (unless in the case of a petition filed against Tenant, the same is dismissed within ninety (90) days); or (iii) Appointment of a trustee or receiver to take possession of substantially all of Tenant's assets located at the Premises or of Tenant's interest in this Lease, where possession is not restored to Tenant within sixty (60) days; or (iv) Attachment, execution or other judicial seizure of substantially all of Tenant's assets located at the Premises or of Tenant's interest in this Lease, where such seizure is not discharged within sixty (60) days.

If, however, during any 365 day period Tenant commits two (2) monetary or three (3) identical non-monetary defaults of which Landlord has notified Tenant, where such notice is required, Landlord may, at its option, immediately exercise any or all remedies available under this Lease or at law or in equity, all without giving Tenant any notice or an opportunity to cure the last (i.e. the third or subsequent) default (notwithstanding any notice and cure provision or other Lease provisions to the contrary).

**SECTION 12.2 LANDLORD'S REMEDIES.** Upon the occurrence of any Event of Default, Landlord will have the option to do any one or more of the following without any notice or demand:

- (a) Landlord may terminate this Lease, in which event Tenant will immediately surrender the Premises to Landlord. If Tenant will fail to do so, Landlord may without notice and prejudice to any other remedy available, enter and take possession of the Premises and remove Tenant or anyone occupying the Premises and its effects without being liable to prosecution or any claim for damages. Tenant will indemnify Landlord for all loss and damage suffered by Landlord because of such termination whether through inability to relet the Premises or otherwise, including without limitation any loss of rent for the remainder of the Term of this Lease. If Landlord elects to terminate this Lease, Tenant's liability to Landlord for damages will survive such termination.
- (b) Landlord may declare the entire amount of all rent past due as well as that which would have become due and payable during the remainder of the Term of this Lease, discounted to present value and reduced by an amount equal to the fair market value of the Lease through the end of the Term, also discounted to present value, to be due and payable immediately. In this event, Tenant will pay the same to Landlord immediately. Such payment will constitute payment of past due rent and payment in advance of the rent stipulated for the remainder of the Term of this Lease. Acceptance by Landlord of the payment of such rent will not constitute a waiver of any then existing default occurring thereafter.
- (c) Landlord may enter upon and take possession of the Premises as agent of Tenant without terminating this Lease and without being liable to prosecution or any claim for damages. Landlord may relet the Premises and in that connection may make any suitable alterations or refurbish the Premises, or both, or change the character or use of the Premises. Landlord will not be required to relet for any use or purpose other than that specified in this Lease or which Landlord may reasonably consider injurious to the Premises, or to any Tenant that Landlord may consider objectionable, in Landlord's reasonable discretion. Landlord may relet all or any portion of the Premises alone or in conjunction with other portions of the Building for a term longer or shorter than the term of this Lease at a rental rate greater or less than the

then current rental rate provided in this Lease and upon such other terms (including the granting of concessions) as Landlord solely determines to be acceptable. If Landlord elects to reenter and relet all or any portion of the Premises, Landlord will be entitled to recover as damages immediately, without waiting until the due date of any future rent, or until the date fixed for Expiration Date of this Lease, the total of all rent owed and unpaid as of the date of the Event of Default. The Landlord can also recover the costs of reentry and reletting including without limitation the cost of any cleanup, refurbishing, removal of Tenant's property and fixtures, expenses from Tenant's failure to quit the Premises and to leave them in the required condition, any remodeling costs, reasonable attorneys' fees, court costs, brokers' commissions, advertising costs, and the difference between the rent and all of Tenant's other obligations under this Lease and the actual rent received by Landlord from the Premises for the period commencing with the date of the Event of Default and continuing through the date designated as the Expiration Date of this Lease. No such reentry or taking possession of the Premises will be construed as an election on Landlord's part to terminate this Lease unless a written notice of such intention is given to Tenant. Landlord, however, will have no duty to relet the Premises and Landlord's failure to do so will not release Tenant's liability for rent or damages. If Landlord elects to enter and relet the Premises, Landlord may at any time thereafter elect to terminate this Lease for Tenant's Event of Default. If Landlord takes possession of the Premises, Landlord will have the right to rent any other available space in the Building before reletting or attempting to relet the Premises.

(d) Landlord may bring suit for the collection of all sums or amounts with respect to which Tenant may be in an Event of Default and/or all damages attributable to any Event of Default by Tenant, or any action seeking injunctive relief to specifically enforce the covenants of Tenant in this Lease, or any other suit or proceeding for any other relief available to Landlord at law or in equity. Landlord may sue periodically to recover damages during the period corresponding to the remainder of the term of this Lease, and no action for damages will bar a later action for damages subsequently accruing.

(e) Landlord may do whatever Tenant is obligated to do by provisions of this Lease and may enter the Premises without being liable to prosecution or claim for damages in order to accomplish this purpose. Tenant will reimburse Landlord immediately upon demand for any expenses that Landlord may incur in complying with the terms of this Lease on behalf of Tenant. Landlord will not be liable for any damages to Tenant from such action, whether caused by negligence of Landlord or otherwise.

A termination of this Lease by Landlord or the recovery of possession of the Premises by Landlord, or any voluntary or other surrender of this Lease by Tenant or a mutual cancellation thereof, will not work a merger and will, at the option of Landlord, terminate all or any existing franchises, concessions, licenses, permits, subleases, subtenancies, departmental operating arrangements or the like between Tenant and any third party with respect to the Premises, or may, at the option of Landlord, operate as an assignment to Landlord of Tenant's interest in the same.

If Tenant will fail to remove any effects which it is entitled to remove from the Premises upon the termination of this Lease, or upon a re-entry by Landlord for any cause whatsoever, or upon Tenant's ceasing to possess the Premises for any reason, Landlord at its option may remove the same and store or dispose of such effects without liability for loss or damage thereto, and Tenant agrees to pay to Landlord on demand any and all expenses incurred in such removal, including court costs, reasonable attorneys' fees, storage and insurance charges on such effects for any length of time the same will be in Landlord's possession; or Landlord at its option, without notice, may sell such effects, or any of them, at private or public sale and without legal process, for such price or consideration as Landlord may obtain, and apply the proceeds of such sale upon any amounts due under this Lease from Tenant to Landlord, and upon the expenses incidental to the removing, cleaning the Premises, selling said effects, and any other expense, rendering the surplus, if any to Tenant; provided, however, in the event the proceeds of such sale or sales are insufficient to reimburse Landlord, Tenant will pay such deficiency upon demand. Tenant acknowledges and agrees that any such disposition of Tenant's property in the above-described manner by Landlord will be deemed to be commercially reasonable and that no bailment will be created by Landlord's exercise of any of its rights under this subparagraph.

Tenant, for itself and any and all persons claiming through or under Tenant including its creditors, upon the termination of this Lease or expiration of the Lease term, or in the event of entry of judgment for the recovery of the possession of the Premises in any action or proceeding, or if Landlord will re-enter the Premises by process of law or otherwise, hereby waives any right of redemption provided or permitted by any statute, law or decision now or hereafter in force. Tenant does hereby waive, surrender, and give up all rights or privileges

which it or they may or might have under and by reason of any present or future law or decision to redeem the Premises or for a continuation of this Lease after having been dispossessed or ejected therefrom by process of law or otherwise.

**SECTION 12.3 BANKRUPTCY OF TENANT.** Nothing contained in this Lease will limit or prejudice the right of Landlord to prove and obtain in proceedings for the termination of this Lease by reason of bankruptcy or insolvency, an amount equal to the maximum allowed by any statute or rule of law in effect at the time when and governing the proceedings in which such damages are to be provided, whether or not such amount be greater, equal to or less than the amount of the damages recoverable under the provisions of this Article.

**SECTION 12.4 WAIVER OF JURY TRIAL AND COUNTERCLAIMS.** Landlord and Tenant hereby waive the right to a trial by jury in any action or proceeding between and among them or their successors on any matters whatsoever arising out of this Lease, the relationship of Landlord and Tenant, Tenant's use or occupancy of the Premises, and/or any claim of injury or damage. Tenant hereby waives the right to interpose a counterclaim in any proceeding instituted by Landlord against Tenant to terminate this Lease (except compulsory counterclaims which must be raised by Tenant or lost), to obtain possession of the Premises, or to recover rent. This will not, however, be construed as a waiver of Tenant's right to assert such claims in any separate action or actions brought by Tenant.

**SECTION 12.5 RIGHTS CUMULATIVE.** All rights and remedies of Landlord herein enumerated will be cumulative and none will exclude any other right or remedy allowed by law, and said rights and remedies may be exercised and enforced concurrently and whenever and as often as occasion therefor arises. Suit or suits for the recovery of damages may be brought by Landlord, from time to time, at Landlord's election, and nothing herein will be deemed to require Landlord to await the date whereon this Lease or the term hereof would have expired had there been no Event of Default.

**SECTION 12.6 LANDLORD DEFAULTS/TENANT REMEDIES.** Landlord will not be in default in the performance of any obligation required to be performed by Landlord under this Lease unless Landlord fails to perform such obligation within thirty (30) days after the receipt of written notice from Tenant specifying in detail Landlord's failure to perform; provided however, that if the nature of Landlord's obligation is such that more than thirty (30) days are required for performance, then Landlord will not be deemed in default if it commences such performance within such thirty (30) day period and thereafter diligently pursues the same to completion. Upon any default by Landlord, Tenant may exercise any of its rights provided at law or in equity.

### **ARTICLE XIII. SURRENDER OF PREMISES**

**SECTION 13.1 SURRENDER.** On the last day of the Term of this Lease or upon the earlier termination thereof for any reason, Tenant will peaceably and quietly surrender the Premises in good order, condition, and repair, broom-clean, reasonable wear and tear and casualty excepted, and will surrender all keys to the Premises to Landlord at the place then fixed for the payment of rent and will inform Landlord of all combinations on locks, safes and vaults, if any, in the Premises. All improvements, alterations, or additions, whether temporary or permanent, made in or upon the Premises, either by Landlord or Tenant, will be deemed a part of the Building and the property of Landlord and will remain upon and be surrendered with the Premises at the expiration or earlier termination of this Lease without compensation to Tenant. However, Landlord may, at its option, require that Tenant remove any or all improvements, alterations, or additions (excluding Landlord's Work, which shall remain in the Premises) at the expiration of the term or such other time at which Tenant ceases to possess the Premises, and restore the Premises to their prior condition; provided, however, that Tenant shall only be required to remove such alterations, improvements or additions if, at the time of Landlord's consent to such alterations, improvements or additions, Landlord advised Tenant in writing that the same must be so removed. Tenant shall remove all furniture, movable trade fixtures, and equipment installed by Tenant at termination of this Lease. All such removals will be accomplished in a workmanlike manner so as not to damage the Premises or the Building, including the structure or structural qualities of the Building or the plumbing, electrical lines, or other utilities. Any such furniture, movable trade fixtures, and equipment not promptly removed by Tenant shall, at Landlord's option be deemed conclusively to have been abandoned by Tenant and may be appropriated, sold, destroyed, or otherwise disposed of by Landlord without notice to Tenant or obligation to compensate Tenant or to account therefor. Tenant will pay Landlord, on demand, all reasonable and actual costs incurred by Landlord in connection with such abandonment. The foregoing provisions will survive expiration or termination of this Lease.

## **ARTICLE XIV. QUIET ENJOYMENT**

SECTION 14.1 LANDLORD'S COVENANT. Landlord represents and covenants that Tenant, provided Tenant is not in an Event of Default, shall and may peaceably and quietly occupy the Premises during the Term of this Lease, including any properly exercised renewal or extension thereof. In addition, Landlord agrees to make reasonable efforts to protect Tenant from interference or disturbance by other tenants or third persons. However, Landlord shall not be liable for any such interference or disturbance nor shall Tenant be released from any of the obligations of this Lease because of such interference or disturbance. Notwithstanding the foregoing, Tenant acknowledges that maintenance and repairs on or about Premises, or construction and renovation work on the Building, may cause inconvenience to tenants or their customers, delays in delivery of services, lack of access to certain areas, limits on available parking and similar consequences. Except as otherwise provided in this Lease, Tenant waives and relinquishes all claims hereafter arising against Landlord with respect to such work, and agrees that no actions taken in connection with such work will permit Tenant to terminate this Lease or relieve Tenant of its obligations hereunder, including, without limitation, the obligation to pay all rent due hereunder.

## **ARTICLE XV. SALE OR MORTGAGING OF THE BUILDING**

SECTION 15.1 SUBORDINATION. Tenant's rights hereunder are hereby declared to be subordinate to the lien of any mortgage or other security interest resulting from any method of financing or refinancing, now or hereafter placed upon the Premises or the land or buildings of which the Premises are a part and to all advances made or hereafter to be made upon the security thereof; provided that every such mortgage or security interest will contain a provision that the mortgagee or holder of the mortgage or security interest will recognize the validity of this Lease in the event of a foreclosure of Landlord's interest so long as Tenant is not in an Event of Default under the terms of this Lease. Landlord represents that there are no mortgages, deeds of trust or ground leases encumbering the Building on the date hereof other than in favor of U.S. Bank, N.A. (the "Existing Lender") and Twentieth Century Markets, Inc. (the "Ground Lessor"). Landlord shall endeavor to obtain and deliver to Tenant a non-disturbance agreement substantially in the same form attached hereto as Exhibit F from the Existing Lender and Ground Lessor. If Landlord has not delivered to Tenant such an agreement within forty-five (45) days after the date of this Lease, Tenant shall have the right, at its option, to terminate this Lease by sending written notice of such election prior to the time Landlord delivers the agreement to Tenant. Landlord shall also endeavor to obtain and deliver to Tenant a non-disturbance agreement substantially in the same form attached hereto as Exhibit F from any future lender or ground lessor.

SECTION 15.2 LIABILITY OF LANDLORD; SALE OF PROPERTY. Under this Lease, the liability of Landlord is limited to Landlord's interest in the Building and land upon which it is situated and any judgment against Landlord will be enforceable solely against Landlord's interest in said Building and land. In the event Landlord transfers its interest in the Building, Landlord shall thereby be released from any further obligation hereunder and Tenant agrees to look solely to the successor in interest of the Landlord for the performance of such obligations.

SECTION 15.3 ESTOPPEL CERTIFICATE. Within ten (10) days after receipt of written request by Landlord, Tenant agrees to deliver in recordable form a certificate to any proposed mortgagee or purchaser or encumbrancer, or to Landlord, in a form reasonably acceptable to such party certifying (if such be the case) that this Lease is in full force and effect and that there are no defenses or offsets thereto, or stating those claimed by Tenant. Tenant's failure to deliver such statement within such time will be conclusive upon Tenant (i) that this Lease is in full force and effect, without modification except as may be represented by Landlord, (ii) that there are no uncured defaults in Landlord's performance, and (iii) that not more than one (1) month's rent has been paid in advance.

## **ARTICLE XVI. EMINENT DOMAIN**

SECTION 16.1 TOTAL TAKING OF LEASED PREMISES. If a condemning authority takes all of the Premises or a portion sufficient to render the Premises reasonably unsuitable for the use Tenant was then making of the Premises, in Tenant's reasonable discretion, this Lease will terminate as of the date the title vests in the condemning authority.

SECTION 16.2 PARTIAL TAKING OF LEASED PREMISES. If a portion of the Premises is condemned and the balance of the Premises not taken is suitable for the use Tenant is then making of the Premises, in Tenant's reasonable discretion, this Lease will terminate as to the portion taken, as of the date title vests in

the condemning authority, and continue as to the remainder. Landlord, at its sole cost and expense, will proceed as soon as reasonably possible to make such repairs and alterations to the Premises as are necessary to restore the remaining Premises to a condition as comparable as reasonably practical to that existing at the time of the condemnation. After the date on which title vests in the condemning authority or an earlier date upon which alterations or repairs are commenced by Landlord to restore the balance of the Premises in anticipation of the taking, the rent will be reduced in proportion to the reduction in area of the Premises as a result of the partial taking.

**SECTION 16.3 TAKING OF BUILDING.** If a condemning authority takes a portion of the Building other than the Premises, which is so substantial as to render in Landlord's reasonable opinion the remainder uneconomic to maintain, Landlord may terminate this Lease by notifying Tenant of such termination within ninety (90) days following the date title vests in the condemning authority, if Landlord also terminates the leases of the other tenants of the Building which are leasing comparably sized space on comparable lease terms.

**SECTION 16.4 SALE IN LIEU OF CONDEMNATION.** Sale of all or a part of the Premises or Building to a purchaser with the power of eminent domain in the face of a threat, or the probability of the exercise of the power, will be treated as a taking by condemnation.

**SECTION 16.5 AWARD.** Landlord will be entitled to all compensation paid as a result of such taking or condemnation without participation by Tenant. Tenant may pursue a claim against and will be entitled to the portion of any award specifically designated by the condemning authority for any personal property of Tenant, loss of business and cost of relocation, provided such claim or award does not diminish or adversely affect the compensation to be paid to Landlord.

## **ARTICLE XVII. WAIVER AND ACCORD AND SATISFACTION**

**SECTION 17.1 WAIVER.** The waiver by Landlord or Tenant of any term, covenant, agreement, or condition contained in this Lease will not be deemed to be a waiver of any subsequent breach of the same or of any other term, covenant, agreement, condition, or provision of this Lease. Nor will any custom or practice which may develop between the parties in the administration of this Lease be construed to waive or lessen the right of Landlord or Tenant to insist upon the performance by the other in strict accordance with all of the terms, covenants, agreements, conditions, and provisions of this Lease. The subsequent acceptance by Landlord of any payment owed by Tenant under this Lease, or the payment of rent by Tenant, will not be deemed to be a waiver of any preceding breach by Tenant of any term, covenant, agreement, condition, or provision of this Lease, other than the failure of Tenant to make the specific payment so accepted by Landlord, regardless of Landlord's or Tenant's knowledge of such preceding breach at the time of the making or acceptance of such payment.

**SECTION 17.2 ACCORD AND SATISFACTION.** No payment by Tenant or receipt by Landlord of a lesser amount than any rent herein stipulated will be deemed other than payment on account of the earliest stipulated rent, nor will any endorsement or statement on any check or any letter accompanying any check or payment as rent be deemed an accord and satisfaction, and Landlord may accept such check or payment without prejudice to Landlord's right to recover the balance of such rent or pursue any remedy which would otherwise be available. Accord and satisfaction, if any, will be accomplished by a separate document executed by both parties.

## **ARTICLE XVIII. MISCELLANEOUS**

**SECTION 18.1 FORCE MAJEURE.** If either Landlord or Tenant will be delayed or hindered in or prevented from the performance of any act required hereunder by reason of any strike, lockout, labor trouble, inability to procure materials, failure of power, restrictive governmental laws or regulation, riot, insurrection, picketing, sit-in, war or other reason of a like nature not attributable to the negligence or fault of the other party delayed in performing work or doing any act required under the terms of this Lease, then the performance of such work or act will be excused for the period of the unavoidable delay and the period for the performance of any such work or act will be extended for an equivalent period. However, this provision will not operate to excuse Tenant from the timely payment of rent or other payments required by the terms of this Lease.

**SECTION 18.2 RELATIONSHIP BETWEEN LANDLORD AND TENANT.** Nothing contained in this Lease will create any relationship between the parties hereto other than that of Landlord and Tenant, and Landlord will not in any way or for any purpose, become a partner of Tenant in the conduct of its business or otherwise, or a member of a joint venture or enterprise with Tenant.

**SECTION 18.3 BROKER'S COMMISSION.** Tenant represents and warrants to Landlord that it has not engaged any broker, finder, other person, or entity who would be entitled to any commission or fee with respect to the negotiation, execution, or delivery of this Lease other than Gelbach, LLC and will indemnify and hold harmless Landlord against any loss, cost, liability, or expense incurred by Landlord as a result of any claim asserted by such other broker, finder, other person, or entity on the basis of any arrangements or agreements made or alleged to have been made by or on behalf of Tenant. Landlord represents and warrants to Tenant that it has not engaged any broker, finder, person, or entity who would be entitled to any commission or fee with respect to the negotiation, execution, or delivery of this Lease, other than the Fiore Companies, Inc. (Landlord's leasing agent) with whom Landlord has listed the Building for lease, and will indemnify and hold harmless Tenant against any loss, cost, liability, or expense incurred by Tenant as a result of any claim asserted by such broker, finder, other person, or entity on the basis of any arrangements or agreements made or alleged to have been made by or on behalf of Landlord. Landlord shall be solely responsible for any commission or fee owed to the Fiore Companies, Inc. Landlord shall also be responsible for paying Gelbach, LLC a commission for the initial term of this Lease transaction according to the terms and provisions of Gelbach, LLC's written recognition, acknowledged by the Fiore Companies and dated July \_\_, 2003, of its right to share the commission payable by Landlord under its listing agreement with the Fiore Companies, Inc.

**SECTION 18.4 ENTIRE AGREEMENT.** This Lease and the exhibits and attachments, if any, set forth all covenants, promises, agreements, conditions and understandings between Landlord and Tenant concerning the Premises and replace and supersede all previous agreements (written or oral), if any, and there are no covenants, promises, agreements, conditions, or understandings, either oral or written, between them other than those herein set forth. Except as herein otherwise provided, no subsequent alteration, amendment, change or addition to or of this Lease will be binding upon Landlord and Tenant, unless the same is reduced to writing and signed by the parties.

**SECTION 18.5 PARTIAL INVALIDITY.** The provisions of this Lease will be deemed separable, and if any term or provision of this Lease or the application thereof to any person or circumstances will to any extent be invalid or unenforceable, the remainder of this Lease, or the application of such term or provision to persons or circumstances other than those as to which it is invalid or unenforceable, will not be affected thereby, and each term, covenant or condition of this Lease will be valid and be enforced to the fullest extent permitted by law.

**SECTION 18.6 ENFORCEMENT OF PROVISIONS.** All costs and expenses, including attorneys' fees in a reasonable amount incurred by Landlord or Tenant in any suit, trial or appeal thereof commenced to enforce the obligations of either under this Lease, will be paid by the losing party to the prevailing party upon demand.

**SECTION 18.7 CAPTIONS AND SECTION NUMBERS.** The captions, section numbers, article numbers and index appearing in this Lease are inserted only as a matter of convenience and in no way define or limit the scope or intent of such sections or articles or this Lease, nor in any way affect this Lease.

**SECTION 18.8 NO OPTION.** Submission of this Lease for examination does not constitute a reservation of or an option for the Premises, and this Lease will become effective as a Lease only upon execution and delivery thereof by Landlord and Tenant.

**SECTION 18.9 RECORDING.** Tenant will not record this Lease without the written consent of Landlord. However, upon request by either party hereto the parties will join in the execution of a memorandum or so-called "short form" of this Lease for the purpose of recordation. Such memorandum or short form Lease will describe the parties, the Premises and the terms of this Lease and will incorporate this Lease by reference.

**SECTION 18.10 SUCCESSORS AND ASSIGNS.** This Lease will be binding upon and inure to the benefit of the parties hereto, their heirs, personal representatives, successors and assigns, except as otherwise herein specifically provided.

**SECTION 18.11 NOTICES.** All notices and demands under this Lease shall be in writing and delivered in person, or sent by pre-paid United States registered or certified mail, return receipt requested or sent by a nationally recognized overnight carrier, at the addresses designated in Section 0.10, or such addresses as hereafter may be designated by either party in writing. Notices that are mailed shall be deemed given on the date of mailing.

**SECTION 18.12 TENANT DEFINED.** The word "Tenant" when used herein will be taken to mean either the singular or the plural and will refer to male or female, to corporations or partnerships, as the case may be, or as grammatical construction will require.

**SECTION 18.13 AUTHORITY.** If Tenant signs this Lease as a corporation or partnership, each of the persons executing this Lease on behalf of Tenant represents and warrants that Tenant is duly formed and in good standing, and that each and every person signing on behalf of Tenant has full corporate or partnership power and authority, as the case may be, to enter into this Lease and has taken all corporate or partnership action, as the case may be, necessary to carry out the transaction contemplated herein, so that when executed, this Lease constitutes a valid and binding obligation enforceable in accordance with its terms. Upon Landlord's request, Tenant will provide evidence satisfactory to Landlord confirming these representations.

**SECTION 18.14 DETERMINATIONS BY LANDLORD.** Whenever in this Lease Landlord is to make any determination or decision, Landlord will make its determination or decision in the exercise of its sole discretion and judgment; however, any such determination or decision will not bind Landlord if it has not been confirmed in writing.

**SECTION 18.15 TIME OF THE ESSENCE.** Time is of the essence in the performance by either party of its obligations hereunder.

**SECTION 18.16 MERGER.** The voluntary or other surrender of this Lease by Tenant, or a mutual cancellation thereof, will not work a merger, and will, at the option of Landlord, terminate all or any existing sub-tenancies or may, at the option of Landlord, operate as an assignment to Landlord of any or all of such sub-tenancies.

**SECTION 18.17 GOVERNING LAW / INTERPRETATION.** This Lease will be governed by and construed in accordance with the laws of the state in which the Building is located. Landlord and Tenant understand, agree, and acknowledge that this Lease has been freely negotiated by both parties; and that, in any controversy, dispute, or contest over the meaning, interpretation, validity, or enforceability of this Lease or any of its terms or conditions, there will be no inference, presumption, or conclusion drawn whatsoever against either party by virtue of that party having drafted this Lease or any portion thereof.

**SECTION 18.18 OPTIONS TO EXTEND.** So long as this Lease is in full force and effect, Tenant will have the right, to be exercised as hereinafter provided, to extend the term of this Lease for two (2) successive periods of three (3) years each on the following terms and conditions:

Except with respect to Base Rent each extended term will be on the same terms, covenants, and conditions as provided in this Lease, except that there will be no privilege to extend the term of this Lease for any period of time beyond the expiration of the second extended term;

Base Rent for the initial extended term shall be determined according to Section 4.2.

Base Rent for the second extended term shall be ninety-five percent (95%) of the Prevailing Market Rent (as determined herein) for substantially similar space in Downtown Madison, Wisconsin taking into account concessions (i.e. tenant improvement allowances for renewals, free rent, pass throughs, etc.) then being offered in the marketplace. The Adjustment To Minimum Rent as set forth in Article IV, Section 4.2 shall continue to operate throughout each extended term;

With respect to the second extended term, this Lease will have previously been extended for the first extended term;

Tenant will exercise its right to an extension in the following manner:

- (a) At least one hundred eighty (180) days prior to the expiration of the initial term and at least one hundred eighty (180) days prior to the expiration of any extended term, Tenant will give notice to Landlord in writing of its election to exercise the right to extend the term of this Lease or subsequent extended term, as the case may be.
- (b) On the giving of such notice, this Lease, subject to the terms of this provision, will be deemed to be extended and the term thereof extended for a period of three (3) years from the date of

expiration of the initial term, or from the date of expiration of the extended term during which such notice is given, as the case may be, without the execution of any further lease or instrument except for a Lease Amendment setting forth the new Base Rent during the renewal period, determined in accordance with the provisions below.

- (c) For the second extended term, if applicable, within ten (10) business days of receipt of Tenant's election, Landlord shall send to Tenant a written notice specifying the Prevailing Market Rent as determined by Landlord in accordance with this Section 18.18. Within thirty (30) days after receipt of such notice from Landlord, Tenant shall send Landlord a written notice of Tenant's acceptance or challenge of Landlord's determination of such rate, provided, however, that in the event that Tenant fails to respond within such thirty (30) day period, Tenant shall be deemed to have accepted Landlord's determination of the Prevailing Market Rent. In the event that Tenant challenges Landlord's determination of the Prevailing Market Rent and Landlord and Tenant are not able to agree on such rate within thirty (30) days (the "Negotiation Period") after Tenant notifies Landlord of Tenant's initial rejection of Landlord's determination of such Prevailing Market Rent, then Landlord and Tenant shall each, within fifteen (15) days after the expiration of the Negotiation Period, select an appraiser, each of whom shall be a licensed real estate broker or a MAI-certified real estate appraiser with at least five (5) years' experience in the metropolitan Madison office market who shall determine the Prevailing Market Rent in accordance with this Section 18.18. The appraisers shall be instructed to complete the appraisal procedure and to submit their written determinations to Landlord and Tenant within thirty (30) days after their meeting. In the event that the determination of the Prevailing Market Rent submitted by Landlord's appraiser is equal to or less than one hundred ten percent (110%) of the determination of the Prevailing Market Rent submitted by Tenant's appraiser, the Prevailing Market Rent shall be the average of such determinations. If the determination of the Prevailing Market Rent submitted by Landlord's appraiser is greater than one hundred ten percent (110%) of the determination of the Prevailing Market Rent submitted by Tenant's appraiser, the appraisers shall, within ten (10) days, appoint a third appraiser with similar qualifications to make such determination of the Prevailing Market Rent. The third appraiser shall be instructed to complete the appraisal procedure and to submit a written determination of the Prevailing Market Rent to Landlord and Tenant within thirty (30) days after such appraiser's appointment. The determination which is neither the highest nor the lowest of the three determinations shall be binding upon Landlord and Tenant as the Prevailing Market Rent. Landlord and Tenant shall each bear the costs of their respective appraisers. The expenses of the third appraiser shall be borne one-half (1/2) by Landlord and one-half (1/2) by Tenant.

**SECTION 18.19 EXPANSION RIGHT.** So long as there are at least four (4) years remaining on the Term of this Lease (as extended), Tenant shall have a right of first offer ("Right of First Offer") to lease adjacent space ("Offer Space") to the Premises subject to the following conditions at the time Tenant exercises the Right of First Offer: a) the Lease must be in full force and effect, b) Tenant shall not be in default under the Lease beyond any applicable cure periods; nor shall Tenant be in default under the Lease at the Commencement Date for the Offer Space (defined below) beyond any applicable cure periods, and c) Tenant's then current financial condition meets the financial criteria reasonably acceptable to Landlord.

Subject to the other terms of this Section, after any part of the Offer Space has or will "become available" for leasing by the Landlord (defined below), Landlord shall not, during the Term of this Lease or any renewal or extension thereof, lease to another tenant that available portion of the Offer Space ("Available Offer Space") without first offering Tenant the right to lease such Available Offer Space, such space to be offered at the same Base Rent and Additional Rent as Tenant's then existing space with Landlord providing a tenant improvement allowance of \$30 per usable square feet to improve the Offer Space in a manner substantially similar to Tenant's original Premises office space. Space shall be deemed to "become available" when the lease for any current tenant of all or a portion of the Offer Space expires or is otherwise terminated. Notwithstanding this, Offer Space shall not be deemed to "become available" if the space is i) assigned or subleased by the current tenant of the space, or ii) re-let by the current tenant of the space by renewal, extension, or renegotiation.

Consistent with this, Landlord shall not lease any such Available Offer Space to another tenant unless and until Landlord has first offered the Available Offer Space to Tenant in writing (the "First Offer Leasing Notice") and Tenant either rejects such offer or a period of thirty (30) days has elapsed from the date that

Tenant has received the First Offer Leasing Notice without Tenant having notified Landlord in writing of its acceptance of such First Offer Leasing Notice and supplied Landlord with current financial statements that satisfy Landlord of Tenant's current financial condition meets the financial criterial reasonably acceptable to Landlord.

If Tenant timely delivers to Landlord, in accordance with the conditions of this Section, written notice of tenants exercise of the Right of First Offer for all of the Available Offer Space (along with Tenant's financial statements) and Landlord determines that Tenant meets all of the conditions provided in this Section, then the Available Offer Space shall be deemed added to the Premises and subject to ther terms and conditions in the Lease, with the exception of those Lease modifications set forth in subsection (a) below.

- (a) If Tenant leases the Available Offer Space pursuant to the terms of this Section, all the obligations, terms, and conditions under the Lease shall also apply to the Available Offer Space except that:
  - a. The Commencement Date for the Lease for the Available Offer Space ("the Commencement Date for the Available Offer Space") shall be the day the Available Offer Space is delivered to the Tenant broom clean, free of tenants or other occupants in its then "as is" condition;
  - b. As of the Commencement Date for the Available Offer Space, Tenant's Pro Rata Share shall be increased to an amount computed to reflect the addition of such Available Offer Space; and
  - c. As of the Commencement Date for the Available Offer Space, the Base Rent shall be increased to reflect the additional space which shall be offered at the same rent per Usable Area as Tenant's original space (as adjusted by Section 4.2).

If Tenant declines or fails to duly and timely exercise its Right of First Offer or fails to meet all of the conditions provided in this Section, Landlord shall thereafter be free to lease the Available Offer Space in portions or in its entirety to any third-party tenant at any time without regard to the restrictions in this Section and on whatever terms and conditions Landlord may decide in its sole discretion.

Within thirty (30) days after the Commencement Date for the Available Offer Space, Landlord and Tenant shall confirm the following in a written amendment to the Lease:

- a. The Commencement Date for the Available Offer Space;
- b. The location and size of the Available Offer Space that was leased by Tenant with an exhibit annexed showing that space crosshatched;
- c. The new Base Rent to be paid by Tenant; and
- d. Tenant's increased Tenant's Pro Rata Share.

This Right of First Offer is personal to the Tenant and shall become null and void upon the occurrence of an assignment of the Lease or a sublet of all or a part of the Premises (except as to assignments and sublets to any parent, subsidiary or affiliate corporation which controls, is controlled by or is under common control with Tenant, or to any corporation resulting from a merger or consolidation with Tenant, or to any person or entity which acquires all or substantially all of the assets of Tenant's business as a going concern).

## **ARTICLE XIX. ATTACHMENTS**

**SECTION 19.1 ATTACHMENTS.** The following are attached hereto and made a part hereof with the same force and effect as if set forth in full herein:

Exhibit "A" Premises/Legal Description.

Exhibit "B" Landlord's and Tenant's Construction Obligations/Initial Plans and Design Specifications.

Exhibit "C" Rules and Regulations.

Exhibit "D" Parking Addendum.

Exhibit "E" Janitorial Specifications

Exhibit "F" Subordination, Non-Disturbance and Attornment Agreement

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals as of the day, month, and year first above written.

TENANT: SONIC FOUNDRY, INC.

By: \_\_\_\_\_

Name: \_\_\_\_\_

Its: \_\_\_\_\_

By: \_\_\_\_\_

Name: \_\_\_\_\_

Its: \_\_\_\_\_

LANDLORD: WEST WASHINGTON ASSOCIATES LLC

By: THE FIORE COMPANIES, INC., Management Agent

By: \_\_\_\_\_

William J. Kunkler, Executive Vice President

By: \_\_\_\_\_

Lee R. Ferderer, Corporate Counsel

**EXHIBIT “A”**

**EXHIBIT "A-1"**

**LEGAL DESCRIPTION**

Lots Four (4), Five (5), Six (6), Seven (7), Eight (8) and Nine (9), Block Sixty-Six (66), in the City of Madison, Dane County, Wisconsin.

## EXHIBIT "B"

### LANDLORD'S AND TENANT'S CONSTRUCTION OBLIGATIONS

#### I. CONSTRUCTION PROCEDURES

Landlord shall construct, at Landlord's cost and expense, the improvements for the Premises set forth in this Exhibit B (the "Landlord's Work") in accordance with the following provisions. Attached hereto as Exhibit B-1 are the initial plans, which have been agreed by Landlord and Tenant (the "Initial Plans"). Within ten (10) days after execution and delivery of this Lease, Landlord shall cause its architect to prepare complete architectural and engineering drawings and specifications (the "Drawings"), based upon the Initial Plans and to deliver the Drawings to Tenant for its review and approval. Within three (3) business days after receipt of the Drawings, Tenant shall approve or disapprove (setting forth the reasons for such disapproval) such Drawings, based upon general compliance with the Initial Plans. In the event of disapproval, Landlord shall cause its architect to incorporate Tenant's requested changes and resubmit to Tenant for its approval. This process shall continue until both parties have agreed to the Drawings. As finally approved, the Drawings shall be called the "Final Plans." Tenant's approval of the Final Plans shall not constitute or imply a representation or warranty of any kind, including whether such Final Plans comply with laws, rules, regulations, ordinances, or permits.

Landlord, at its sole cost and expense, will cause the Final Plans to be filed with the appropriate governmental agencies in such form (buildings notice, alteration or other form) as may be required. If Tenant will desire any additional work after the Final Plans have been approved (such request to be called a "Change Order"), Tenant will cause similar plans and specifications for such work to be drawn at Tenant's sole expense, either by arranging therefor with Landlord's architect and/ or engineer, or by consultants of its own selection. All such plans and specifications for Change Orders will be submitted to Landlord for Landlord's review and approval. Landlord reserves the right to give directives to Tenant's architect or engineer, at Tenant's expense, for the purpose of insuring that such Change Orders conform to the Building requirements. Landlord covenants it will not unreasonably withhold or delay such review.

Change Orders shall be performed by Landlord; any costs associated with Change Orders shall be borne by Tenant. Prior to commencing any such Change Order work, Landlord will submit to Tenant written estimates of the cost of any such Change Order work above the costs indicated for the Final Plans. If Tenant will fail to approve or disapprove any such estimate within one (1) week from the date of submission thereof by Landlord, then Landlord shall not be required to perform the Change Order request.

Landlord will permit Tenant and its agents reasonable access to the Premises during normal working hours prior to the date specified for the commencement of Tenant's occupancy under this Lease, in order that Tenant may perform through its own contractors such cabling and installation of furniture ("Tenant's Work") as Tenant may desire at the time that Landlord's contractors are working in the Premises. All contractors engaged by Tenant as permitted by Landlord will be bondable, licensed contractors, possessing good labor relations, capable of performing quality workmanship and working in harmony with Landlord's general contractor and other contractors on the job. Such license is further conditioned upon Workers' Compensation and public liability insurance and property damage insurance, all in amounts and with companies and on forms reasonably satisfactory to Landlord, being provided and at all times maintained by Tenant's contractors engaged in the performance of the Tenant's Work, and certificates of such insurance being furnished to Landlord, prior to proceeding with the Tenant's Work. If at any time such entry will cause disharmony or interference with Landlord's mechanics or contractors, this license may be withdrawn by Landlord upon forty-eight (48) hours written notice to Tenant. Such entry will be deemed to be subject to all of the terms, covenants, provisions and conditions of this Lease except as to the covenant to pay rent. Landlord will not be liable in any way for any injury, loss or damage which may occur to Tenant, its employees, contractors, agents, workmen and mechanics, or any one or more of them, or to any of Tenant's decorations or installations so made prior to commencement of the term of the Lease, the same being solely at Tenant's risk and Tenant hereby agrees to indemnify and hold Landlord harmless from any and all claims therefor or arising therefrom, except and to the extent caused by the negligence or willful misconduct of Landlord or Landlord's employees, contractors, agents, or representatives.

Landlord shall perform the Landlord's Work in a good and workmanlike manner in accordance with all laws, including the ADA. Landlord will cause the repair or replacement of any defects in material or workmanship,

if any, in the improvements installed by Landlord, if Landlord receives written notification of such defect from Tenant within the period of one (1) year after Substantial Completion. Tenant's sole and exclusive remedy against Landlord will be for the repair. Landlord will not be responsible for any defect of any nature in the improvements installed by Landlord of which Landlord is not so notified within such one (1) year period. LANDLORD MAKES NO WARRANTIES, EXPRESS OR IMPLIED, INCLUDING BUT NOT LIMITED TO IMPLIED WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE, IN IMPROVEMENTS EXCEPT THE WARRANTIES EXPRESSLY SET FORTH HEREIN. TENANT'S SOLE REMEDY FOR THE BREACH OF ANY APPLICABLE WARRANTY WILL BE THE REMEDY SET FORTH HEREIN. Tenant agrees that no other remedy, including without limitation incidental or consequential damages for lost profits, injury to person or property, or any other incidental or consequential loss will be available to Tenant.

## **II. TENANTS CONTRIBUTION TO LANDLORD'S WORK**

- A. Landlord, as part of Landlord's Work, shall acquire and install Landlord's standard proximity card readers in quantities and locations specified by Tenant, acquire and install anti-static vct tile as specified by Tenant in the areas labeled "data closet" and "manufact." on the Initial Plans and attached hereto, and provided a 75kva service and feeder to Tenant's Premises. Tenant agrees to reimburse Landlord in the amount of \$12,100.00 for these items of Landlord's Work ("Tenant's Contribution Towards Landlord's Work"). Tenant's Contribution Toward's Landlord's Work shall be due and payable upon Substantial Completion of the Premises as defined in Section 3.2.

## **III. TENANT'S WORK**

- A. Tenant will do and perform at its expense all Tenant's Work. Without limiting the foregoing, Tenant's Work shall include data wiring, acquisition and installation of Liebert-type specialized air conditioning and power back-up and power conditioning equipment, acquisition and installation of any specialized fire suppression systems (i.e. FM 200), acquisition and installation of all workstations including final electrical connections thereto and any specialized electrical work required in the manufacturing and data areas shown on the Initial Plans. In addition, all office furniture and equipment shown on the Initial Plans are for illustration purposes only. Before doing any Tenant's Work, Tenant must receive prior written permission from Landlord. No work performed by Tenant is in lieu of current rent or an advance rental payment

Tenant's construction will comply in all respects with applicable federal, state, county, and local statutes, ordinances, regulations, laws, and codes. Tenant will be responsible for all necessary permits and approvals required to pursue Tenant's Work. Tenant's Work will not hinder or interfere with the conducting of business by other tenants. Tenant's contractor or subcontractors will not at any time damage, injure, interfere with or delay any other construction within the Building.

**EXHIBIT “B-1”  
INITIAL PLANS & DESIGN SPECIFICATIONS**

**EXHIBIT "C"**  
**RULES AND REGULATIONS**

1. Access may be had by Tenant to the Common Areas and to the Premises at any time between the hours of 7:00 a.m. and 6:00 p.m., Monday through Friday, legal holidays excepted. At other times access to the Building may be refused unless the person seeking admission has an access card. Tenant shall be responsible for all persons for whom Tenant requests passes or access cards and shall be liable to Landlord for all acts of such persons. Landlord shall in no case be liable for damages for the admission or exclusion of any person from the Building. Subject to Landlord's security system, Tenant shall have access to the Building garage and Premises 24 hours/day, 7 days/week.
2. Upon the Commencement Date, Landlord will furnish, at Landlord's cost, Tenant's then current employees with keys and/or access cards to the main Building entry doors and to Tenant's Premises. Thereafter, Landlord will make a reasonable charge for any additional keys and/or access cards. Tenant will not have such keys duplicated. Tenant will not alter any lock, install a new or additional lock or any bolt on any door of its Premises without prior written consent of Landlord. Upon Termination of this Lease, Tenant will deliver to Landlord all keys and/or access cards to doors in the Building and Premises.
3. Sidewalks, doorways, vestibules, halls, stairways and similar areas will not be unreasonably obstructed by Tenant or used for any purpose other than ingress or egress to and from the Premises and for going from one to another part of the Building. Except as otherwise provided in the Lease, Tenant will not enter the mechanical rooms, air conditioning rooms, electrical closets, janitorial closets, or similar areas outside of the Premises or go upon the roof of the Building without the prior written consent of Landlord.
4. Landlord will provide and install, at Landlord's cost, all letters or numerals on entrance doors to the Premises; all such letters and numerals will be in the building standard graphics, and no others will be used or permitted on the exterior of, or which may be visible from outside the Premises. Said graphics/signs may be updated or changed from time to time at Landlord's discretion.
5. Landlord in conspicuous places in the Building will place directories. No other directories will be permitted unless previously consented to by Landlord in writing. Landlord reserves the right to restrict the amount of directory space utilized by Tenant. Directory strips displaying the names and location of Tenant's company, officers or employees must be ordered through Landlord at Landlord's sole cost. The cost of resigning after Tenant's initial occupancy shall be borne by Tenant.
6. No signs, advertisements or notices will be painted or affixed on or to any windows or doors, or other part of the Building, or that are visible from the exterior of the Building, except of such color, size and style and in such places as will be first approved in writing by Landlord.
7. Landlord will have the power to prescribe the weight and position of iron safes, bookshelves, or other heavy equipment, which will in all cases, to distribute weight, stand on plank strips at least two inches thick. All damage done to the Building by taking in or putting out any property of a Tenant, or done by Tenant's property while in the Building, will be repaired at the expense of Tenant.
8. Tenant will notify the Building manager when safes, furniture or other heavy equipment are to be taken in or out of the Building, and the moving will be done under the supervision of the Building Manager, after written permit from Landlord. Persons employed to move such property must be approved by Landlord.
9. No furniture, packages, or bulky material of any kind will be received in the Building or carried up or down stairs or in the elevators, except in the manner and at the times specified by Landlord. Tenant will not use in the delivery, receipt, or other movement of supplies and personal property, any hand trucks or carts other than those equipped with rubber tires and side guards.
10. Corridor doors, when not in use, will be kept closed.
11. Except as otherwise provided in the Lease, Tenant will not conduct mechanical or manufacturing operations, cook or prepare food (except microwave cooking for the benefit of Tenant's employees), or place or use any inflammable, combustible, explosive or hazardous fluid, chemical, device, substance or material in or about the Building without prior written consent of Landlord. Tenant will comply with all rules, orders, regulations, and requirements of the applicable Fire Rating Bureau, or other similar body.

12. Electric space heaters will not be used without Landlord's prior written permission.
13. No flashing lights or search lights, loud speakers, television sets, phonographs, radios or other devices will be used in a manner so as to be heard or seen outside of the Premises without the prior written consent of Landlord.
14. Tenant will not make or permit any improper noise, cause disturbances, or create odors in the Building, or otherwise unreasonably interfere in any way with other tenants, or persons having business with them.
15. Tenant will cooperate with Landlord's employees in keeping Premises neat and clean.
16. Nothing will be swept or thrown into the corridors, halls, elevators shafts or stairways. No birds or animals will be brought into or kept in or about the Building, other than animals assisting disabled persons.
17. No machinery other than standard office machines such as typewriters, calculators, copying machines, personal computers, and similar machines will be operated on Premises without the prior written consent of Landlord.
18. Tenant will not place anything, including but not limited to furniture, fixtures, equipment, merchandise displays, decorations, advertisements and signs, in any of the Common Areas of the Building or the sidewalks adjacent thereto, without prior written approval of Landlord.
19. Tenant will not in or on any part of the Common Areas: a) vend or solicit orders for sale or distribution of any merchandise, service periodical, book, pamphlet or other material; b) distribute any circular, handbill, placard, or other material; c) solicit membership in any organization or group or contribution for any purpose; d) create a nuisance or hazard; e) discard refuse, except in designated receptacles; or f) damage any sign, lighting fixture, landscaping material, other improvements, property of customers, or property of others within the Building.
20. The plumbing facilities will not be used for any other purpose than that for which they are constructed, and no foreign substance of any kind will be thrown therein, and the expense of any breakage, stoppage, or damage resulting from a violation of this provision will be borne by Tenant who will, or whose employees, agents or invitees will have caused it.
21. Bicycles or other vehicles will not be permitted in the offices, halls, or corridors of the Building, nor will any obstruction of sidewalks or entrances of the Building by such be permitted.
22. Without limitation upon any of the provisions of this Lease, Tenant will refer all contractor representatives, installation technicians, janitorial workers and other mechanics, artisans, and laborers rendering any service in connection with the repair, maintenance, or improvement of the Building to Landlord for Landlord's supervision, approval, and control before performance of any such service. This will apply to all work performed in the Building, including without limitation, installation of telephones, computers, electrical, and electronic devices of any kind and attachments and installations of any nature affecting floors, walls, woodwork, trim, windows, ceilings, equipment, or any other portion of the Building. Plans and specifications for such work, prepared at Tenant's sole expense, will be submitted to Landlord and will be subject to Landlord's prior written approval in each instance before the commencement of work.

No blinds, shades, curtains, draperies or similar items visible from the exterior of the Building (other than Landlord's Building Standard mini-blinds) shall be installed without Landlord's prior written consent.

**EXHIBIT "D"**  
**PARKING ADDENDUM**

So long as this Lease remains in effect and Tenant is not in an Event of Default hereunder, Tenant will have a non-exclusive license to use up to 12 parking spaces located in the Building in consideration for Tenant's payment of \$115.00 per month which will be due and payable as Additional Rent at the same time as are Tenant's monthly installments of Base Rent. This non-exclusive license will commence on the date on which Tenant's rental obligation under the Lease commences, and will terminate upon the Lease Expiration Date (as extended). The monthly payment hereunder will be increased on each Escalation Date by three percent (3%).

Upon not less than 30 days notice, Landlord may alter the number of parking spaces which Tenant will have the right to use, provided that the number of spaces provided to Tenant will not be diminished below that number of the parking spaces set forth above and the monthly payment hereunder will not be increased. Landlord reserves the right to specifically assign and reassign from time to time any or all of said parking spaces among the tenants of the Building in any manner in which Landlord determines in its sole discretion and Tenant will, upon not less than 10 days notice from Landlord, furnish Landlord with the state automobile license number assigned to its automobile or automobiles and the automobiles of all of its employees and representatives employed or working in the Premises and Tenant agrees to comply with such other request as Landlord may make in Landlord's enforcement of any parking control program. Notwithstanding the existence of any such control, Landlord will not be responsible to Tenant, its employees, agents, representatives, customers or invitees for any violation of any parking control program implemented by Landlord.

Landlord will maintain up to thirty (30) visitor parking stalls in the Building charging market rates for such hourly visitor parking. Tenant shall be responsible for validating its own visitors' use of the metered parking according to the policies and procedures set forth by Landlord and applied consistently to all tenants of the Building and shall be responsible for reimbursing Landlord for such costs as Additional Rent hererunder.

The provisions of this Exhibit supplement and are specifically subject to all provisions of the Lease.

**EXHIBIT "E"**

**MINIMUM JANITORIAL SPECIFICATIONS**

**OFFICE & WORK AREAS**

Monday-Friday

- Vacuum carpets
- Dust mop hard surface floors
- Empty wastebaskets, clean and install liners as needed
- Clean and polish water fountains
- Dust and spot clean conference room tables
- Lock all doors to secure building and set alarm (if used)

Weekly

- Spot wash hallway walls
- Dust desktops, tabletops, credenzas, file cabinets and other Office furniture (desks will be dusted only if cleared)
- Dust windowsills, baseboards, ledges and moldings

Monthly

- High level dusting
- Spot wash interior walls
- Vacuum air conditioning vents
- Edge vacuum carpet borders and difficult to vacuum areas
- Clean sidelight windows

Semi-Annual

- Scrub and wax hard surface floors (if required)
- Wash exterior windows

As Needed

- Remove all recyclables in compliance with applicable law

## LAVORATORIES

Monday-Friday

- Empty waste receptacles
- Clean and polish mirrors and fixtures
- Service and refill all dispensers (soap, tissues, towels)
- Clean and disinfect urinals, commodes and basins
- Wet mop floors with disinfectant

Monthly

- Clean all partitions and ceramic tile walls
- Scrub and wax hard surface floors (if required)

## ENTRYWAYS & HALLWAYS

Monday-Friday

- Clean all door glass
- Spot wash walls, as needed
- Remove all trash
- Clean and polish any water fountains
- Vacuum all carpet
- Remove stains in carpet

**EXHIBIT F**

**NON-DISTURBANCE AND ATTORNMENT AGREEMENT**

THIS NON-DISTURBANCE AGREEMENT ("Agreement"), made as of the \_\_\_\_\_ day of \_\_\_\_\_, 2003, by and among Twentieth Century Markets, Inc. ("Ground Lessor"), U.S. Bank, N.A. ("Mortgagee") and \_\_\_\_\_ ("Tenant").

**WITNESSETH:**

**WHEREAS**, by a Lease ("Lease") dated \_\_\_\_\_, \_\_\_\_\_, West Washington Associates LLC ("Landlord") has leased to Tenant the property described on Exhibit "A" (the "Premises");

**WHEREAS**, the Premises are encumbered by a Mortgage in favor of Mortgagee ("Mortgage");

**WHEREAS**, the Premises are subject to a Ground Lease of which Ground Lessor is the Lessor ("Ground Lease");

**WHEREAS**, pursuant to Lease, the Lease and Tenant's interest therein is subordinate to the Mortgage and the Ground Lease; and

**WHEREAS**, Section 15.51 of the Lease requires that Landlord deliver this Agreement.

**NOW, THEREFORE**, for a good and valuable consideration the sufficiency and receipt of which is hereby acknowledged and in consideration of the Lease and the covenants contained therein, the parties agree as follows:

1. Tenant enters into this Agreement with the understanding and upon the condition that, notwithstanding the Subordination of Tenant's Lease to the Mortgage and the Ground Lease, for so long as Tenant shall duly and punctually perform and observe all of its covenants, terms and obligations under the terms of the Lease and shall not be in default thereunder, after expiration of any applicable period within which to cure such default: (a) Mortgagee and Ground Lessor shall recognize the validity of the Lease and all of Tenant's rights thereunder; and (b) notwithstanding any default by Landlord under the Mortgage or the Ground Lease, foreclosure of the Mortgage or Ground Lease by Mortgagee or Ground Lessor, or their succession to title by deed in lieu of foreclosure, Mortgagee or Ground Lessor (or their successors by grant, assignment, mortgage foreclosure or otherwise) shall not alter, disturb or interfere with Tenant's possession and use of the Premises during the remainder of the term of the Lease or any extension thereof.
2. If Mortgagee or Ground Lessor shall become the owner of the Premises, or if the Premises shall be sold by reason of foreclosure, exercise of power of sale or other proceeding to enforce the Mortgage or the Ground Lease, or if the Premises shall be transferred by deed in lieu of foreclosure, prior to the termination of the Lease then: (a) the Lease shall continue as a direct Lease between Tenant and the then Owners of the Premises (including Mortgagee or Ground Lessor) or the Grantee under any deed as a result of foreclosure or in lieu of foreclosure) upon, and subject to all of the terms, covenants and conditions of the Lease, for the balance of the term of the Lease; and (b) Tenant shall attorn to Mortgagee, Ground Lessor or such other owner as its Landlord to the same extent and with the same

force and effect as though the Lease were directly from the Mortgagee or Ground Lessor (or other such owner) to Tenant; provided, however, that Mortgagee or Ground Lessor shall not: (i) be liable for any act or omission of any prior Landlord (including Landlord under the Lease); (ii) be subject to any offsets or defenses which Tenant might have against any prior landlord (including Landlord); (iii) be bound by any rent or additional rent which Tenant might have paid in advance to any prior landlord (including Landlord) for a period of excess of one month or by any security deposit, cleaning deposit or other prepaid charge which Tenant might have paid in advance to any prior landlord (including Landlord); (iv) be bound by any amendment, modification or termination of Lease made without Mortgagee's or Ground Lessor's written consent; or (v) be liable for any refusal or failure to perform or complete Landlord's work or otherwise to prepare the Premises for occupancy in accordance with the provisions of the Lease.

3. Mortgagee or Ground Lessor shall not include Tenant in a foreclosure proceeding involving Premises, except as required by law and to the extent Mortgagee or Ground Lessor does not thereby disturb Tenant's rights to the Premises as set forth in the Lease.
4. This Agreement shall also bind and benefit the heirs, legal representatives, successors and assigns with the respective parties hereto, and all covenants, conditions and agreements herein contained shall be construed as running with the land.

IN WITNESS WHEREOF, the parties hereto have executed and delivered this Agreement as of the day and year first above written.

[TENANT]

By: \_\_\_\_\_

STATE OF

\_\_\_\_\_ )

)ss.

COUNTY OF

\_\_\_\_\_ )

Personally came before me this \_\_\_ day of \_\_\_\_\_, 2003, the above named \_\_\_\_\_ to me known to be the \_\_\_\_\_ of \_\_\_\_\_ who executed the foregoing instrument by virtue of the authority vested in him as \_\_\_\_\_, and acknowledged that he executed the same as the voluntary act and authorized deed of the corporation.

\_\_\_\_\_  
Notary Public, residing in \_\_\_\_\_ County

My Commission: \_\_\_\_\_

## FIRST AMENDMENT TO LEASE

**THIS AGREEMENT** made and entered into this 1st day of October 2003, by and between West Washington Associates, LLC, a Wisconsin limited liability company ("Landlord"), and Sonic Foundry, Inc. ("Tenant").

**WHEREAS**, in a lease agreement between the above parties ("Lease"), Tenant leased from Landlord the premises known as Suite 775 of Network222, 222 West Washington Avenue, Madison, WI 53703 ("Premises"), for a term commencing October 1, 2003, upon the covenants and conditions contained therein.

**WHEREAS**, Landlord and Tenant now desire to amend the Lease on the terms herein stated.

**THEREFORE**, in consideration of the mutual covenants and conditions contained herein, the parties hereby agree as follows:

1. Section 0.03 shall be amended to include Suite 140 as depicted in Exhibit A attached hereto and comprised of 754 square feet rentable. The Commencement Date for Suite 140 shall be the Commencement Date as set forth in the Lease.
2. Suite 140 shall be added to the Lease on a month-to-month basis. Landlord or Tenant may terminate the Lease with respect to Suite 140 with thirty (30) days advance written notice to the other party.
3. Landlord and Tenant acknowledge that Tenant shall use Suite 140 for its general office storage requirements and for no other purpose.
4. The Base Rent for Suite 140 shall be \$754.00 per month and shall be subject to Minimal Annual Escalation as set forth in Section 0.06 (Article IV, Section 4.2) of the Lease.

Tenant has occupied and/or inspected the Premises and knows the condition thereof, and acknowledges that no warranties, expressed or implied, are made with respect thereto. Tenant acknowledges that neither Landlord nor its agents have made any representations as to the condition of the Premises or as to the state of repair thereof.

All other conditions of the Lease remain unchanged.

This Agreement shall also be binding upon and inure to the benefit of the successors and assigns of the respective parties thereto.

**IN WITNESS WHEREOF**, the parties hereto have set their hands and seals on the date and year above written.

### WEST WASHINGTON ASSOCIATES, LLC, LANDLORD

By: /s/ WILLIAM J. KUNKLER

William J. Kunkler, Executive Vice President

By: /s/ L. R. FERCERER

Lee R. Fercerer, Corporate Counsel

SONIC FOUNDRY, INC.

By: /s/ JUSTIN JAECK

Justin Jaeck, Director of Operations

## LIST OF SUBSIDIARIES

1. International Image Services Corporation – Incorporated in the State of Maryland
2. International Image Services, Inc. – Incorporated in Ontario, Canada
3. Sonic Foundry Media Systems, Inc. – Incorporated in the State of Maryland

**Sonic Foundry, Inc.**  
**Annual Report on Form 10-K**  
**For the Year Ended September 30, 2003**

**EXHIBIT 23**

**CONSENT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS**

We consent to the incorporation by reference in (i) the Registration Statement (Form S-8 filed on March 26, 1999, amended on September 8, 2000) pertaining to the Sonic Foundry, Inc. 1995 Stock Option Plan, the Sonic Foundry, Inc. Non-Employee Directors Stock Option Plan and the Shareholder Relations Consultant Warrants, (ii) the Registration Statement (Form S-3 filed on November 12, 1999) pertaining to shares of common stock issuable upon conversion of debentures and exercise of certain warrants, (iii) the Registration Statement (Form S-3 filed on October 25, 1999) pertaining to shares of common stock issuable upon exercise of certain warrants, (iv) the Registration Statement (Form S-8 filed on June 30, 2000) pertaining to the Sonic Foundry, Inc. Employee Stock Purchase Plan, (v) the Registration Statement (Form S-8 filed on September 8, 2000) pertaining to the 1999 Non-Qualified Stock Option Plan, (vi) the Registration Statement (Form S-3 filed on November 7, 2000, amended on February 16, 2001) pertaining to shares of common stock issuable upon conversion of exchangeable shares and the exercise of exchangeable share options and warrants (vii) the Registration Statement (Form S-3 filed on May 15, 2000) pertaining to shares of common stock issuable upon the exercise of warrants, (viii) the Registration Statement (Form S-8 filed on November 21, 2001) pertaining to the Sonic Foundry, Inc. 2001 Deferred compensation Plan, (ix) the Registration Statement (Form S-8 filed on December 21, 2001) pertaining to the MediaSite, Inc. Employee Retention Plan, (x) the Registration Statement (Form S-8 amended on December 21, 2001) pertaining to the amended 1999 Non-Qualified Stock Option Plan, (xi) the Registration Statement (Form S-3 effective July 17, 2002) pertaining to shares issued and issuable pursuant to the conversion of debt and exercise of warrants, (xii) the Registration Statement (Form S-3 effective August 16, 2002) pertaining to shares issued and issuable pursuant to the exercise of warrants and (xiii) the Registration Statement (Form S-3 effective September 13, 2002) pertaining to shares issued and issuable pursuant to the exercise of warrants of our report dated November 14, 2003, with respect to the financial statements and schedule of Sonic Foundry, Inc. included in this Annual Report (Form 10-K) for the year ended September 30, 2003.

/s/ ERNST & YOUNG

Milwaukee, Wisconsin  
December 22, 2003

**Sonic Foundry, Inc.  
Annual Report on Form 10-K  
For the Year Ended September 30, 2003**

**SECTION 302 CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

Exhibit 31.1

**CERTIFICATIONS**

I, Rimas P. Buinevicius, certify that:

1. I have reviewed this annual report on Form 10-K of Sonic Foundry, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: December 22, 2003

By: /s/ Rimas P. Buinivicius

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By: Rimas P. Buinivicius  
Title: Chief Executive Officer

**Sonic Foundry, Inc.**  
**Annual Report on Form 10-K**  
**For the Year Ended September 30, 2003**

SECTION 302 CERTIFICATION OF CHIEF FINANCIAL OFFICER

Exhibit 31.2

**CERTIFICATIONS**

I, Kenneth A. Minor, certify that:

1. I have reviewed this annual report on Form 10-K of Sonic Foundry, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: December 22, 2003

By: /s/ Kenneth A. Minor

By: Kenneth A. Minor

Title: Chief Financial Officer

**Sonic Foundry, Inc.  
Annual Report on Form 10-K  
For the Year Ended September 30, 2003**

**SECTION 906 CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND  
CHIEF FINANCIAL OFFICER**

Exhibit 32

**Statement**

Solely for the purposes of complying with 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, we, the undersigned Chief Executive Officer and the Chief Financial Officer of Sonic Foundry, Inc. (the "Company"), hereby certify, based on our knowledge, that the Annual Report on Form 10-K of the Company for the year ended September 30, 2003 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: December 22, 2003

By: /s/ Rimas P. Buinivicius

By: Rimas P. Buinivicius  
Title: Chief Executive Officer

By: /s/ Kenneth A. Minor

By: Kenneth A. Minor  
Title: Chief Financial Officer