SONIC FOUNDRY INC
Form 10-K
November 22, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal period ended September 30, 2011

OR

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

Commission File Number 000-30407

SONIC FOUNDRY, INC.

(Exact name of registrant as specified in its charter)

MARYLAND	**39-1783372**
(State or other jurisdiction of	**(I.R.S. Employer**

incorporation or organization)	**Identification No.)**
222 W. Washington Ave, Madison, WI 53703	**(608) 443-1600**
(Address of principal executive offices)	**(Issuer s telephone number)**
Securities registered pursuant to Section 12(b) of the Act:	**None**
Securities registered pursuant to Section 12(g) of the Act:	**Common stock par value $0.01 per share**

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

Yes ¨ No þ

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

Yes ¨ No þ

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 þ 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 þ

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes þ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	þ

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

Yes ¨ No þ

The aggregate market value of the registrant s common stock held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the Registrant s most recently completed second fiscal quarter was approximately $51,399,000.

The number of shares outstanding of the registrant s common equity was 3,839,648 as of November 17, 2011.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2011 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, 2012.

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Explanatory Note:

Effective November 16, 2009, Sonic Foundry, Inc. implemented a one-for-ten reverse split of its stock. All share amounts and per share data in this Annual Report on Form 10-K have been adjusted to reflect this reverse stock split.

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

PART I

ITEM 1. BUSINESS

Who We Are

Sonic Foundry, Inc. is a web communications technology leader, providing webcasting, lecture capture and knowledge management solutions for higher education institutions, businesses and government agencies worldwide. Powered by our patented webcasting platform, Mediasite®, Sonic Foundry empowers people to transform the way they communicate. We help our customers connect within a dynamic, evolving world of shared knowledge and envision a future where learners and workers around the globe use webcasting to bridge time and distance; accelerate research, productivity and growth; and reduce the environmental impact of traditional education and business communications.

Sonic Foundry solutions include:

- Mediasite Recorders for capturing multimedia presentations
- Mediasite EX Server platform for streaming, archiving and managing online presentation content
- Mediasite Events for turnkey meeting, conference and event webcasting services based on the Mediasite platform
- Mediasite Services for hosting, installation, training and custom development
- Mediasite Customer Assurance for annual hardware and software maintenance and technical support

Today, over 2,300 customers using more than 5,500 Mediasite Recorders in presentation venues around the world are capturing hundreds of thousands of multimedia presentations with millions of viewers.

Sonic Foundry, Inc. was founded in 1991, incorporated in Wisconsin in March 1994 and merged into a Maryland corporation of the same name in October 1996. Our executive offices are located at 222 West Washington Ave., Madison, Wisconsin 53703 and our telephone number is (608) 443-1600. Our corporate website is www.sonicfoundry.com. In the Investor Information section of our website we make available, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to reports required to be filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as soon as reasonably practicable after the filing of such reports with the Securities and Exchange Commission.

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Challenges We Address

Every organization faces a fundamental need to communicate information efficiently to individuals who need it. Universities and colleges need to connect instructors with students for advanced learning. Corporations strive for successful communication and collaboration among colleagues to provide value to customers. Government agencies must keep partners, stakeholders and constituents informed to operate effectively. And yet, communication and e-learning challenges remain, including:

Ensuring students academic and professional success

- Enabling learners to watch or review course material to improve retention and positively impact grades
- Providing distance learners with the same quality education as on-campus students
- Helping students balance education, career and family commitments
- Increasing enrollment without the expense of new classrooms and facilities
- Capturing complex graphics where visual clarity is essential for learning

Connecting with a geographically-dispersed audience

- Simultaneously addressing people in multiple locations
- Holding meetings, conferences and events when it is not feasible for everyone to attend
- Transmitting timely information that is crucial for all to receive
- Requiring employees, regardless of time zone or schedule, to attend training

Improving productivity and overall organizational knowledge

- Avoiding the need for participants to leave their desks to attend a conference, meeting or training

- Maintaining productivity while in training
- Reducing time to train new hires
- Increasing retention by avoiding distractions, interruptions or absence
- Keeping everyone on the same page to prevent false starts and forgotten directives
- Documenting meeting content for later review
- Extending the life and value of conferences, meetings and events
- Maintaining a rich library of organizational knowledge
- Documenting and preserving expertise from a retiring workforce

Reducing logistical and financial impacts

- Cutting travel expenses and carbon footprints
- Eliminating repetition of the same presentation to different audiences
- Reducing repeated costs for printing, mailing and meeting expenses
- Enabling individuals to attend professional conferences in light of travel bans and budget cuts

Avoiding cumbersome and restrictive technologies

- Maintaining the way presenters present without requiring technical expertise in presentation systems
- Capturing and sharing knowledge in real-time without pre-authoring or pre-uploading of content or needing substantial post-production time
- Removing significant time and specialized expertise to manage presentation systems

Sonic Foundry Solutions

Sonic Foundry is changing the way organizations share and use information. Our solutions include:

Mediasite Recorders for capturing multimedia presentations

Mediasite EX Server platform for streaming, archiving and managing online presentation content

Mediasite Events for turnkey meeting, conference and event webcasting services based on the Mediasite platform

Mediasite Services for hosting, installation, training and custom development

Mediasite Customer Assurance for annual hardware and software maintenance and technical support

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Mediasite Recorders are designed with presenters in mind. They automatically record what presenters say and show, without changing how they present, and webcast it online. Mediasite Recorders streamline the capture and delivery of any presenters video and any presentation images shown from any presentation source such as a laptop, tablet, document camera, whiteboard or even medical instrumentation. The result is high resolution, interactive presentations that can be immediately watched via the web on a computer or mobile device live or on-demand. With the industry s simplest workflow, Mediasite Recorders eliminate time-consuming authoring, slide uploads and post-production work. Plus, seamless integration with existing audio/video and educational technology means organizations can confidently scale multimedia webcasting throughout their academic or corporate enterprise.

We offer Mediasite Recorders for the following environments:

- A room-based Mediasite Recorder (RL Series) for presentation facilities like conference and training rooms, lecture halls, auditoriums and classrooms
- A mobile Mediasite Recorder (ML Series) for portability to off-site events, conferences, trade shows or multiple venues throughout an organization

Mediasite EX Server is a powerful platform for delivering and managing live and on-demand webcasts. It greatly simplifies content management by providing a single system to schedule, catalog, customize, secure, track and integrate recorded presentations. It brings order and control to valuable content libraries by making it easy to manage hundreds of system users, thousands of recorded hours and as many viewers as needed.

Mediasite EX Server allows organizations to:

- Save time and staffing by scheduling presentations to be automatically recorded without an operator
- Customize and brand their presentation content
- Automatically create online content catalogs without web development or integration skills
- Save valuable time, improve content retention and enhance productivity by empowering viewers with search capabilities that pinpoint key words anywhere in their presentation library and play back relevant content where search terms occur
- Secure presentations and Mediasite system access for authorized users
- Incorporate audience interactivity through polls and Q&A

- Track and report on viewing activity to see who is watching what presentations when and to analyze viewing patterns that may correlate to improved learning outcomes, increased performance or program effectiveness

- Centrally monitor and control the recording functions of multiple Mediasite Recorders for increased operator efficiency

- Integrate Mediasite content into other course/learning/content management systems, portals, blogs or online communities

- Extend their rich media content to users with vision or hearing impairments through support for closed captions and screen readers, while also meeting federal or state accessibility requirements

- Leverage existing network technologies for content distribution efficiency and performance

- Reliably scale to meet the webcasting needs of departmental and enterprise-wide implementations alike

- Choose the deployment model that best suits their environment, whether on-premise or hosted in the Sonic Foundry datacenter

Mediasite Events equips customers with a team of trained technicians who work on-site to webcast conferences and events. Event webcasting:

- Enhances attendee experience with online presentation catalogs

- Reaches a wider audience, making presentations available to those not able to attend

- Brands presentations using organization logos, colors and messages

- Provides a real-time record of what took place

- Links handout materials with the full presentation, including audio, video and graphics

- Offers sample content to entice new attendees to participate

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Mediasite Services enable organizations to quickly and easily take advantage of the Mediasite platform, without having to wade through the IT or network complexities associated with their own infrastructure. Mediasite Services include:

- Hosting or Software as a Service (SaaS): Our pay-as-you-go service offerings provide content hosting, delivery and management of Mediasite content using Sonic Foundry s data center and infrastructure. These managed services allow organizations of all sizes to jump start their web communications initiatives quickly and simply. They provide a low-risk way to implement online multimedia communications before bringing hosting requirements in-house and can offer a hassle-free long-term solution.

- Installation: Sonic Foundry provides onsite consulting and installation services to help customers optimize their deployment and efficiently integrate Mediasite within their existing AV and IT infrastructures, processes and workflows.

- Training: To maximize customers return on investments, skilled trainers provide the necessary knowledge transfer so organizations feel confident in using, managing and leveraging Mediasite s capabilities. On-site training is customized to specific requirements and skill levels, while online training provides convenient anytime access to a web-based catalog of training modules.

- Custom Development: Sonic Foundry streamlines how Mediasite interfaces with a customer s specific technologies, internal policies, workflow or content delivery systems through project-based development.

Mediasite Customer Assurance provides customers annually renewable maintenance and support plans for their Mediasite solutions giving them access to Sonic Foundry technical expertise and Mediasite software updates. With a Mediasite Customer Assurance contract, customers are entitled to:

- Software upgrades and updates for Mediasite Recorders and Servers

- Unlimited technical support assistance

- Extension of their recorder hardware warranty

- Advanced recorder hardware replacement

- Authorized access to the Mediasite Customer Assurance Portal where they can access software downloads, documentation, knowledge base articles, tutorials, online training and technical resources at any time.

Nearly all our customers purchase a Customer Assurance plan when they purchase Mediasite Recorders or Servers.

What Sets Mediasite Apart?

Market Leadership Two leading industry analyst firms recognize Sonic Foundry s Mediasite as the leading, best-of-breed platform for lecture capture. Frost & Sullivan awarded Sonic Foundry three consecutive Market Share Leadership Awards for Lecture Capture in 2010, 2009 and 2007 (no report was published in 2008). The Frost & Sullivan Award for Market Share Leadership is presented to the company that demonstrates excellence in capturing the highest market share within its industry and recognizes the company s leadership position in terms of revenues or units. Wainhouse Research also recognizes Mediasite as a streaming and lecture capture market leader for distance education and e-learning in their report, *The Distance Education and e-Learning Landscape V2* (December 2008). Among Wainhouse s evaluation criteria are innovation, market understanding, overall viability, product strategy and customer experience. According to the report, Sonic Foundry ranks highest from the perspective of product offering depth and ranks among the leaders in its ability to execute. Mediasite has also been voted the Best Webcasting Platform in the last four consecutive *Streaming Media* Readers Choice Awards (2007-present), and named 2011 Best Video Capture, Production and Publishing Solution by *eLearning! Magazine*.

Ease of use We believe that presenters should not need to know anything about the technology that is facilitating their online communication. Automated or schedule-based recording simplifies what has previously been a technical and complex workflow. As a result, presenters can present as they normally do, which enables non-technical, line of business and subject matter experts to feel comfortable communicating via Mediasite. Similarly, viewers need nothing more than a web browser to watch Mediasite presentations.

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Comprehensive content management We understand the need to bring order to a growing presentation library so content can be found, used and re-purposed to derive maximum value. Organizations must find ways to manage that content, and Sonic Foundry believes a complete solution focuses not only on the recording of knowledge, but also the retention and management of that knowledge in a system specifically designed for rich media. Mediasite automatically creates searchable online catalogs that index and organize presentations with customizable playback experiences. With integration support for leading enterprise directories, all content can be secured to allow/deny access to specific groups or individuals based on roles and permissions. Mediasite also allows organizations to track and generate reports for every presentation and/or user of the system, letting them see exactly who is watching what, when and how long.

Reliability Whether starting at the department level with a couple rooms or at the enterprise level with a campus- or company-wide implementation, Mediasite was developed to be the single platform to confidently and reliably scale to organizations webcasting needs. More than 2,300 customers around the world trust Mediasite and its proven design to webcast critical information, enrich daily communications and retain their organizational knowledge.

Dynamic multimedia experience The Mediasite experience takes into account different individual learning styles auditory, visual and kinesthetic providing an interactive format that engages the viewer via different modalities to increase content comprehension and retention. Many other webcast solutions focus on PowerPoint as the predominant or only source of content and may not support video. We understand that learning materials and supporting visuals come in many different forms, and Mediasite Recorders flexible capture options support input from any laptop , tablet, whiteboard, document camera, medical instrumentation and more. In November 2006, the United States Patent and Trademark Office granted Sonic Foundry a patent on Mediasite s unique method to capture and automatically index and synchronize what the presenter says (audio and video) with visual aids (RGB-based presentation content) and instantly stream them both over the Internet. Mediasite is also the first lecture capture solution to offer Microsoft® Silverlight®-enabled and HTML5-enabled Players which provide a more dynamic, user-controlled viewing experience. Adding to Mediasite s interactivity is the ability to incorporate polls, Q&A or links to other related reference materials supporting the learning process. Support for video closed captioning benefits those with hearing disabilities, but also empowers users with powerful keyword search to pinpoint and play back content of interest within a Mediasite presentation, Mediasite Catalog or an entire Mediasite library.

Software as a Service (SaaS) deployment option To minimize IT challenges, network infrastructure issues and expertise required to install, configure and maintain Mediasite within the enterprise, Sonic Foundry hosting provides organizations a low-risk method of using the complete Mediasite platform within a state-of-the-art datacenter.

Customer support Sonic Foundry and the growing Mediasite community provide a reliable, collaborative support network for all Mediasite customers. Our breadth of field-based system engineers and responsive customer care ensure that customers have readily available resources committed to their success. The Mediasite User Group (MUG) is one of the most vibrant, diverse and rapidly expanding user communities for lecture capture, online training and e-learning. MUG members share ideas and get feedback year-round from community experts through online forum discussions, participate in live quarterly meetings to exchange best practices and network at UNLEASH, the annual Mediasite User Conference.

Sonic Foundry Solutions in Higher Education and the Enterprise

Sonic Foundry solutions are rapidly emerging as the standard for recording, delivering and managing one-to-many multimedia webcasts for higher education and corporate, healthcare or government enterprises

Sonic Foundry solutions in higher education:

Among post-secondary institutions, Mediasite is used for:

- Online lectures (blended/hybrid learning): students review content outside of in-class instruction
- Distance learning: off-campus students learn remotely online
- Continuing education: professionals learn online or supplement classroom experiences
- Special events: commencement, guest speakers, sporting events
- Faculty training and development
- Research and collaboration: faculty document and present findings
- Recruitment and orientation: campus tours, financial aid instructions University business: leadership meetings, alumni relations, outreach

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Through interviews, many higher education institutions report that Mediasite:

Improves student learning outcomes

- o Lets students watch and re-watch presentations at their convenience, boosting information retention
- o Replicates the in-class experience for online students or those unable to attend class
- o Contributes to enhanced grades
- o Caters to different learning modalities

Enables their institution to remain competitive

- o Allows quick development and delivery of cost-effective online programs
- o Supports higher enrollment and/or tuition without new classrooms
- o Improves student retention and matriculation
- o Helps attract students and faculty

Empowers faculty

- o Allows them to teach as usual without learning new technology
- o Promotes greater in-class interactivity rather than copious note-taking

- o Improves student outcomes

- o Enables knowledge sharing and collaboration with colleagues

- o Supports time-shifting, letting faculty travel to conferences or present findings without missing class

Boosts campus outreach

- o Bolsters recruitment efforts

- o Increases awareness and reach of campus events

- o Enhances alumni relations

Given the technology pedigree of today s college students, this move to online learning makes perfect sense as these students have never known a world without personal computers, mobile devices and the web. The delivery options for a modern education are akin to the electronic delivery of music that emerged several years ago. Students demand immediate access to their coursework regardless of time or place.

Recent trends such as the slowing economy and lingering high fuel prices continue to drive more students, particularly adult learners, to online education through enrollment in blended or hybrid courses with a traditional on-campus component or through fully online distance learning programs. Historically, graduate programs and STEM (science, technology, engineering and math)-oriented degree programs in schools of medicine, nursing, engineering or business have comprised the majority of our academic customer base. We are now experiencing heightened market demand for lecture capture within undergraduate and community college programs as well.

According to the Sloan Consortium report, *Class Differences: Online Education in the United States, 2010*, online enrollments the past several years have been growing considerably. The 21 percent growth rate for online enrollments far exceeds the 2 percent growth of the overall higher education student population. The survey of more than 2,500 colleges and universities nationwide finds more than one in four students approximately 5.6 million were enrolled in at least one online course in the fall 2009 term, one million more than in the fall 2008 term. Over three-quarters of survey respondents from public institutions report that online learning is as good as or better than face-to-face instruction Three-quarters of institutions also report that the economic downturn has increased demand for existing online courses and programs. Almost two-thirds of for-profit institutions now say that online learning is a critical part of their long term strategy, with 60 percent of academic leaders reporting there is increasing competition for online students.

Similarly, the National Center for Education Statistics released a Stats in Brief report from the U. S. Department of Education, *Learning at a Distance: Undergraduate Enrollment in Distance Education Courses and Degree Programs* (October 2011), showing that the percentage of undergraduates enrolled in at least one online class increased from 8 percent to 20 percent between 2000 and 2008.

Community colleges, specifically, have significantly increased their number of blended or hybrid and web-enhanced courses. The Instructional Technology Council s 2010 Distance Education Survey Results: *Trends in eLearning: Tracking the Impact of eLearning at Community Colleges* (May 2011) reported a nine percent increase in distance education enrollments, higher than the seven percent increase in overall higher education student enrollment. Over

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20 percent of community colleges offer blended/hybrid courses up 15 percent from last year. Factors cited for contributing to the increase in elearning enrollments include downturn in the economy (37 percent), typical growth for distance education classes (39 percent) and new enrollment initiatives (12 percent). The study also showed that overall, 77 percent of community colleges offer audio/video streaming, and another 9 percent plan to offer in the next year.

According to The Campus Computing Project s *Campus Computing2010: The 21st National Survey of Computing and Information Technology in American Higher Education*, sixty percent of all universities agree/strongly agree that lecture capture is an important part of our campus plan for developing and delivering instructional content.

In their *2010 21st Century Campus Report* (June 2010), CDW-G reports multimedia content streaming is one of the top five technologies identified by students, faculty and staff as extremely important to today s college students. According to student responses, 44 percent of high school students want to use recorded class lectures in college, and of IT professionals surveyed, 61 percent of institutions currently offer virtual learning opportunities.

Analysts predict the lecture capture market will more than triple over the next six years. Frost & Sullivan analysts estimate lecture capture revenues will reach over $192 million by 2016, exhibiting a nearly 22 percent compound annual growth rate (CAGR) for the six-year period (*World Lecture Capture Solutions Markets* report, 2010). Wainhouse Research predicts in *Differentiating Higher Ed and Primary/Secondary Applications: Why Key Technologies Vary in Acceptance and Adoption* (September 2010), lecture capture is now and will remain one of the most deployed new classroom technologies in higher education over the next three to five year period. They report 29 percent of higher education survey respondents indicate they are using some lecture capture, with 42 percent at mainstream usage.

In September 2008, Sonic Foundry sponsored a research project with the University of Wisconsin E-Business Institute which resulted in the study, *Insights Regarding Undergraduate Preference for Lecture Capture*. A survey was sent to 29,078 undergraduate and graduate students at the University of Wisconsin-Madison in April 2008. Average response rate exceeded 25 percent. Of the survey participants, a significant number of undergraduates (47 percent) have taken a class in which lectures were recorded and made available online. Eighty-two percent of the undergraduates in the sample strongly preferred a course that records and streams lecture content online versus a course that only features in-room instruction. Students reported better retention, improved ability to review for exams and greater engagement during classes with lecture capture. Over half of the undergraduates indicated that, even after course completion, having course material available online would be important and that there was interest in accessing online material in their professional lives. Over 60 percent of the sample was willing to pay for lecture capture services. Of those willing to pay, the majority of undergraduates (69 percent) expressed a preference to pay on a course-by-course basis rather than having lecture capture fees bundled with existing technology fees.

Several universities have conducted their own independent studies to assess the impact of Mediasite on student performance. This year, the University of Maryland-Baltimore Dental School announced new independent survey results demonstrating the positive impact of Mediasite on student outcomes. A Mediasite campus since 2006, the school compiled several years of student surveys after amassing five-thousand captures with half a million views. The latest results come from feedback by 118 graduating seniors and are available in the webinar, Evaluating Lecture Capture s Impact on Student Outcomes which can be viewed at http://sofo.com/ada52.

Student survey results reveal:

- 97% felt Mediasite made it easier to learn
- 73% used a combination of in-class lectures and Mediasite to enhance their studies

98% indicated they watched most or all of the lectures online

40% said Mediasite helped them prepare for the boards

50% agreed or strongly agreed that lecture capture attracted them to the Dental School

74% would recommend the dental school to potential students because of Mediasite

95% expressed satisfaction with Mediasite

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During the spring semester of 2008, the University of New Mexico surveyed almost a thousand undergraduate and distance education students about their Mediasite usage and found:

90 percent of respondents agreed or strongly agreed that Mediasite should be available for other courses

62 percent of students used Mediasite at least half of the time or more to review or watch lectures

77 percent had good or excellent experiences using Mediasite, and 77 percent of respondents agreed or strongly agreed that Mediasite wa easy to use

85 percent described the quality of the Mediasite recordings as good or excellent

42 percent used Mediasite to review lectures due to absence, but several students noted they never missed class

54 percent used Mediasite to review for quizzes and exams often or always with 30 percent always using Mediasite to review

67 percent responded they agreed or strongly agreed that Mediasite improved their overall learning of course content

56 percent responded they agreed or strongly agreed that Mediasite improved their overall grade in the course

Penn State Hershey Medical Center and College of Medicine, a Mediasite campus since January 2004, deployed a pilot program at the onset of the 2007-2008 academic year to record lectures to first year medical students. During this academic year, lectures were viewed a total of 22,451 times, averaging 59.1 views per lecture by a class of 154 students. Mediasite use increased throughout the academic year, with 97 percent of students using Mediasite to review lectures by the semester s end. Almost half of the students surveyed (41 percent) cited reviewing complicated material as the number one motivator for using Mediasite. The majority (88 percent) agreed that Mediasite helps them achieve their educational goals. Much fewer (25 percent) said podcasting had the same effect. Faculty members reported that recording their lectures did not decrease class attendance. The survey also revealed a correlation between the grading method and the use of Mediasite. Students watch lectures more often via Mediasite for classes where grades are awarded as honors, high pass, pass and fail versus simply pass/fail.

The Paul Merage School of Business at the University of California, Irvine, surveyed students in its 2007-2008 MBA for Executives and MBA for Health Care Executives programs. Ninety-one percent used Mediasite to view lectures, 71 percent found they were more engaged in lectures when they didn t have to focus on taking copious notes and 83 percent said they learned more in courses when lectures were available on demand. The survey also determined that 93 percent of the students would choose an MBA program that produces Mediasite course content over a school with traditional in-class instruction alone. Furthermore, 82 percent would pay higher tuition for a program that streams and archives instruction, with almost half willing to pay between $2,000 and $5,000 more for their two-year degree.

To remain relevant, colleges and universities are striving to differentiate themselves through technical leadership as a means to attract these tech-savvy students, while balancing their campus technology improvements with systems that faculty will embrace and adopt. As a result, the education market is beginning to restructure and increase investments around online learning. We believe the visible integration of multimedia learning content into core university applications and the success of bundled online learning technology solutions are two healthy indicators for the widespread adoption of online campus lectures.

To date, Sonic Foundry has installed Mediasite in large lecture halls, auditoriums and classrooms of campuses nationwide. We now see more and broader expansions and integrations of Mediasite at the campus-wide level. Course and learning management systems like Blackboard®, Moodle, Desire2Learn®, Angel, or Sakai are ubiquitous in the education enterprise. As the foundation for e-learning, these systems are rapidly moving beyond simply aggregating related course documents (handouts, assignments, course syllabi) to becoming students single-source portal for all course-related materials including recorded multimedia content like online lectures. Mediasite s packaged integrations for Blackboard and Moodle, the leading course management systems used in higher education, address the need to make learning content accessible to students when and where they need it. Similarly, video content management platforms are starting to emerge as repositories for campus media-centric content. These platforms provide additional opportunities through which to make Mediasite content accessible to faculty, staff or students.

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Sonic Foundry Solutions in the Enterprise:

Within medium to large corporate, healthcare and government enterprises, Mediasite has numerous applications.

In corporate enterprises it is used for:

- Executive communications: state of the enterprise speeches, all-hands meetings
- Workforce development: training, HR briefings, policy documentation
- Sales and marketing: demonstrations, product announcements, webinars, channel relations
- Internal knowledge repositories: technical training, research collaboration, user-generated content
- Customer support: product tutorials, self-guided troubleshooting
- Investor relations: earnings calls, analyst briefings, annual reports
- Conferences and events: user group, sales and annual meetings

In health-related enterprises it is used for:

- Education: continuing medical education, grand rounds, seminars, student/patient simulations
- On-demand medical information
- Caregiver training
- Emergency response coordination

- Public health announcements
- Research and collaboration
- Conferences and events

In government agencies it is used for:

- Program management: relief work, military coordination, emergency preparedness
- Community outreach: committee meetings, public safety announcements
- Training, workshops and events
- Executive and legislative communications: constituent relations, public speeches, debates

Through interviews across these verticals, enterprise customers report that Mediasite:

- Expands training and communications opportunities
  - o Enables them to offer training to more and larger audiences
  - o Captures knowledge from a retiring workforce
  - o Supports the creation and sharing of user-generated content
  - o Aides in building a knowledge library
  - o Extends the life of conferences and events
- Cuts travel and meeting expenses
  - o Eliminates redundant speaking engagements
  - o Opens communication channels with dispersed audiences regardless of location or time zone
  - o Provides the ability to address everyone at once

Boosts efficiency

- o Enables immediate communication of time-sensitive information
- o Delivers the message directly to the desktop to reduce downtime
- o Allows participants to watch when it s convenient to avoid interruptions and increase retention
- o Reduces new hire training time

Helps build stronger teams

- o Fosters direct management/employee communications
- o Supports more frequent, clearer communication with colleagues and staff
- o Keeps all employees aligned
- o Cultivates team morale and collaboration

Less than a decade ago, the only people in the enterprise talking openly about online multimedia were audiovisual specialists in information technology or media services units, and even these people were skeptical about what benefits streaming would hold for the enterprise. Now, knowledge workers, executives, event planners and people in training, sales, human resources and research and development are pushing for online multimedia and webcasting as part of their e-learning initiatives. They have a business need to be seen and heard by their colleagues, and the return on investment (ROI) for multimedia online learning is real and measurable.

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Claire Schooley, senior analyst with Forrester Research, Inc., wrote in the April 2009 report, The ROI of eLearning, Online learning earns companies a positive ROI in less than a year. If you have a business that is spread across many locations, it makes good business sense to implement an online learning program as a replacement for some face-to-face learning and as a complement to other instructor-led training in the form of blended learning. Whether employees take compliance training, desktop skills development, or leadership training, online learning is flexible, consistent, and repeatable with minimal travel costs. The keys to success include excellent eLearning content that engages the learner; good change management plans for this new way of learning; and technology that is scalable and easy to use to manage the learning. She goes on to state that Outside of subject areas where face-to-face interaction is necessary, recent research indicates that no significant differences exist in the effectiveness of learning through classroom, online, or self-study. Self-paced eLearning allows learners to assimilate content at their own speed often 20% to 50% faster than in a classroom

Gartner vice president and distinguished analyst, Carol Rozwell, echoes the value of e-learning in the January 2009 report, Key Issues for Corporate Learning Systems, 2009. She states, Getting people up to speed quickly and efficiently is critical for all roles, but especially for those positions with a high turnover rate, such as sales and customer support. Reducing time to competency demands that employees, customers and business partners are connected to high-quality learning content so they can achieve workplace performance objectives. In times of financial stress, interest in e-learning increases. It gives learners the opportunity for training without the expense of travel and it allows the company to support green initiatives.

In its 2011 report, *World Enterprise Video Webcasting Solutions Market,* industry analyst Frost & Sullivan, cites several drivers contributing to the growth of the worldwide enterprise video webcasting market:

- Video webcasting allows enterprises to reduce costs and enhance communication
- Video webcasting is increasingly cheaper to deploy
- Video webcasting integrated into the enterprise portal helps enhance shelf life of video content
- Maturing capabilities of enterprise IT departments help drive buy-in for video webcasting deployments
- Interactive functionality including tools for reporting and analytics enhance the value proposition of enterprise video webcasting

The technology market for enterprise webcasting solutions that support many e-learning and business communications initiatives is growing as well. In Wainhouse Research s, *Enterprise Streaming Solutions Market Size and Forecast* (June 2011), senior analyst and partner, Ira Weinstein, estimates the enterprise streaming products market (which includes content capture and management solutions and related services for installation, training and support) to be $503 million in 2011. This market will expand to an estimated $1.424 billion by 2015 with Weinstein projecting a CAGR for the period around 29 percent.

In the September 2011 *Enterprise Webcasting Services Market Size and Forecast* also by Wainhouse Research, Weinstein estimates the 2011 market for hosted streaming application platforms supporting live virtual events (specifically excluding web conferencing offerings and consumer-focused video streaming services) to be $358 million. By 2015, Weinstein predicts the market will expand to $925 million, exhibiting a 28 percent CAGR over the four-year period, driven by increasing awareness of webcasting as a business application and growing acceptance of SaaS/hosted webcasting offerings.

Future Directions

Because webcasting and lecture capture are becoming an everyday part of the way people work and learn, we are driven to shorten the time it takes people not only to capture and share their information but also to find the information they need. Today, leading universities use Mediasite for lecture capture and corporations webcast training, executive communications and events. We envision a future where people around the globe use webcasting to bridge time and distance; accelerate research, productivity and growth; and reduce the environmental impact of traditional education and business communications. As a company, we are helping create the libraries of tomorrow with technology that does not compound the world s information overload. We are working to put a human face on all online knowledge, and we believe the world will be more knowledgeable and more connected as a result.

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Supporting this vision, our ongoing innovations center on:

Supporting ubiquitous content playback on all popular mobile devices.

Developing deployment options to meet the webcasting needs for organizations of all sizes. This includes:

- Significant investment, development and evolution of our current Mediasite hosting platform to provide Software as a Service (SaaS). This alternative to traditional on-premise deployments provides an ideal way to minimize IT challenges and potential webcasting risks while affordably extending high performance, fault tolerant webcasting to small and large customers alike.

- Content capture solutions that economically scale across entire organizations, allowing anyone to record and share their knowledge or expertise, regardless of location.

Evolving Mediasite s content management capabilities to accommodate organizations existing digital video assets.

Integrating with and embedding Mediasite content into enterprise portals, learning and course management systems, content management repositories, blogs or online communities.

Enabling context-based viewing of webcasts within online environments that enable and encourage discussion around the content.

Segment Information

We have determined that in accordance with FASB ASC 280-10, we operate in only one segment as we do not disaggregate profit and loss information on a segment basis for internal management reporting purposes to our chief operating decision maker. Therefore, such information is not presented.

We have included the cash effect of billings not recorded as revenue, which are deferred for GAAP purposes, in arriving at non-GAAP net income or loss. Our services are typically billed and collected in advance of providing the service which requires minimal cost to perform in the future. Billings are a better indicator of customer activity and cash flow than revenue is, in management s opinion, and is therefore used by management as a key operational indicator. Billings is computed by combining revenue with the change in unearned revenue. Total billings for Mediasite product and support outside the United States totaled 25 percent and 19 percent in 2011 and 2010, respectively.

Our largest individual customers are typically value added resellers (VARs) and distributors since the majority of our end users require additional complementary products and services which we do not provide. Accordingly, in fiscal 2011 and 2010 one master distributor, Synnex Corporation (Synnex), contributed 24 percent and 32 percent, respectively, of total world-wide billings. A second master distributor, Starin Marketing, Inc. (Starin), contributed 26 percent and 22 percent of total world-wide billings in fiscal 2011 and 2010, respectively. As master distributors, Synnex and Starin fulfill transactions to VARs, end users and other distributors. No other customer represented over 10 percent of billings in 2011 or 2010.

Sales

We sell and market our offerings through a sales force that manages a channel of value-added resellers, system integrators, consultants and distributors. These third party representatives specialize in understanding both audio/video systems and IT networking. In fiscal 2011, we utilized two master distributors in the U.S. and approximately 150 resellers, and sold our products to over 1,000 total end users. Our focus has been primarily in the United States and primarily to customers we have identified as having the greatest potential for high use; that is, organizations with presenters, trainers, lecturers, marketers, event planners and leaders who have a routine need to communicate to many people in higher education, government, health and certain corporate markets. Despite our primary attention on the United States market, reseller and customer interest outside the United States has grown and accordingly, we allocated five sales professionals to address international demand. To date, we have sold our products to customers in over 50 countries outside the United States. Total billings for Mediasite product and support outside the United States totaled 25 percent and 19 percent in fiscal 2011 and 2010, respectively.

Vertical market expansion: Over half our revenue is realized from the education market. Recent trends such as the slowing economy are driving more students, particularly adult learners, to seek online education options. Similarly, demand for lecture capture within undergraduate, community college and blended learning programs is demonstrating growth. This development represents an emerging trend beyond the traditional academic customer base for the company, which has primarily consisted of graduate, distance learning and technical degree programs.

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For our higher education as well as corporate, government and association clients, we anticipate weak economic conditions will expand market demand for more outsourced services versus licensed sales. Over the last two years, the company has made extensive capital and technology investments to advance its services model with turnkey event webcasting, comprehensive hosting/Software as a Service (SaaS), and e-commerce capabilities that position us well to deliver more diversified business services.

With our Mediasite Events group, we continue to see growing demand for conference webcasting and hybrid events (conferences which combine both face-to-face meeting and viewing over the web). These event-based communication, education and training applications, combined with outsourced webcasting services, are expected to drive the company s corporate sales activities going forward.

Repeat orders: Many customers initially purchase a small number of Mediasite Recorders to test or pilot in a department, school or business unit. A successful pilot project and the associated increase in webcasting demand from other departments or schools leads to follow up, multiple Recorder orders as well as increased Mediasite Server capacity. In fiscal 2011, 67 percent of billings were to preexisting customers compared to 70 percent in fiscal 2010.

Renewals: As is typical in the industry, we offer annual support and maintenance service contract extensions for a fee to our customer base. Nearly all customers purchase a Customer Assurance plan with their initial Mediasite Recorders and Servers, and the majority renew their contracts annually.

Marketing

Marketing efforts span the spectrum of thought leadership and best practices webinars, tradeshows, product demonstrations, websites, public relations, social media, direct mail, e-mail campaigns, newsletters, print and online advertising, sponsorships, Mediasite User Group community building, annual user conference, brochures, white papers and analyst relations. We often request and receive press release quotes and written or multimedia testimonials from satisfied, high-profile reference customers, particularly those that demonstrate innovative and valuable uses of the Mediasite platform and Mediasite Events. We solicit respected industry magazines and trade organizations to review our product and use advisors as introductions to new channels or customers. We have a large, growing database of potential customers in the education, government and corporate marketplaces and have established a process of targeting specific verticals that have a direct and demonstrated need for our offerings.

Operations

We contract with third parties to build the hardware of our Mediasite Recorders and purchase quantities sufficient to fill specific customer orders, including purchases of inventory by resellers. Quantities are maintained in inventory by the third party providers and shipped directly to the end customer or reseller. The hardware manufacturers provide a limited one-year warranty on the hardware, which we pass on to our customers who purchase a Mediasite Customer Assurance support and maintenance plan. We have alternative sources of manufacturing for some of the products we produce and believe there are numerous additional sources and alternatives to the existing production process. We have experienced delays in production of our products and component parts used in our products in the past and expect to maintain greater quantities of inventory in the future to mitigate the risk of such delays. To date, we have not experienced any material returns due to product defects.

OTHER INFORMATION

Competition

In the lecture capture and webcasting market we face competition from various companies that provide related, but different, communication technologies. These include:

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Web conferencing solutions (e.g. Adobe, Cisco/WebEx, Microsoft and Citrix). Although part of the overall online multimedia communications landscape, these solutions are designed primarily for collaborative communications versus one-to-many communications like Mediasite. Many organizations acknowledge that they need both technologies one-to-many webcasting and collaborative web conferencing to appropriately address their different communication requirements.

Video conferencing solutions (e.g. Polycom, TANDBERG (now Cisco) and Sony). These solutions are designed primarily for one-to-one or group communications with high levels of interactivity and collaboration. Like web conferencing, many organizations use both video conferencing and webcasting. Mediasite integrates with videoconferencing endpoints from Polycom and TANDBERG to record and manage interactive meetings, discussions and distance learning courses alongside other Mediasite content.

Authoring tools (e.g. Polycom Accordent PresenterPLUS and TechSmith Camtasia). Unlike webcasting, web conferencing or video conferencing, which are forms of online multimedia communication that capture and distribute/stream content, these solutions are production-oriented tools designed to create and edit multimedia content only. Some organizations will use these desktop tools to create training content by manually integrating existing audio, video, images, branding and other visual elements into a multimedia presentation which can then be published to a web or streaming server for distribution. This process can require a significant amount of production effort and user expertise in presentation authoring. Mediasite is capable of ingesting content produced by popular desktop tools like TechSmith s Camtasia Relay or in video formats like Windows Media or H.264, allowing the content to be delivered, managed and secured alongside all other Mediasite content.

Online video services and virtual meeting platforms (e.g. INXPO, Livestream, ON24, Onstream Media, InterCall, Thomson Reuters, Unisfair and Wall Street Webcasting). These companies offer services or SaaS-based platforms that either allow audio and video to be captured from a presenter s computer (often with supporting materials uploaded in advance), produced streaming video services or 2D/3D virtual environments that may or may not include rich media webcasts.

Other vendors such as Echo360, Tegrity, Panopto, TechSmith, Crestron and Accordent Technologies (now Polycom), provide lecture capture or webcasting capabilities, but differ in their technology approach, particularly in the lecture capture arena. Mediasite is an appliance- or room-based platform for lecture capture. It provides a full integrated system designed around an automated purpose-built recording appliance to capture, publish and manage rich media content. This transparent recording automation means no presenter intervention which leads to the broadest end-user adoption across campuses. Room-based appliances are capable of streaming live or on-demand and can leverage the full breadth of in-room audio/visual technology. A room-based platform like Mediasite also includes complete content management for captured multimedia presentations.

Other lecture capture solutions are implemented as software applications designed to capture and publish rich media content from a desktop. Such solutions can be used to create and distribute content in advance of a lecture, and are dependent upon a third-party content management platform, typically the institution s course management system. Software applications for lecture capture support on-demand streaming only and require PC integration with varying levels of presenter intervention and recording knowledge but contain certain features some of our potential customers require.

Lastly, laptop-resident desktop tools capture and publish non-rich media (limited video and presentation graphics) and like software applications support only on-demand streaming and require a third-party content management platform. Desktop tools require the greatest degree of presenter intervention, technical confidence and support. Laptop-resident desktop tools are prevalent on many campuses.

Some current and potential customers have developed their own home-grown webcasting or lecture capture solutions which may compete with Mediasite. However, we often find many of these organizations are now looking for a solution that requires less internal maintenance and effort, offers comprehensive management capabilities and a less cumbersome workflow.

The more successful we are in the growing market for lecture capture and webcasting, the more competitors are likely to emerge. We believe that the principal competitive factors in our market include:

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Support for live as well as on-demand streaming to any device type

Ease of use and application transparency to speed user adoption

Complete rich media content management in a single platform

Highly scalable appliance-based approach requiring minimal AV and IT support to address enterprise requirements

Reliability and performance

Price

Security of content, applications and services

Ability to integrate with third-party solutions and services

Flexible deployment and acquisition options, including both on-premise and SaaS models, to suit various budgets

Breadth and depth of pre- and post-sale customer service and support

A significant reference-able customer base

Ability to introduce new products and services to the market in a timely manner

Intellectual Property

The status of United States patent protection in the Internet industry is not well defined and will evolve as the U.S. Patent and Trademark Office grants additional patents. Currently two U.S patents that have been issued to us, and four U.S. patent applications are pending. We may seek additional patents in the future. We do not know if our pending patent applications or any future patent application will result in any patents being issued with the scope of the claims we seek, if such patents are issued at all. We do not know whether the patents which were recently approved or any patents we may receive in the future will be challenged, invalidated or be of any value. It is difficult to monitor unauthorized use of technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States, and our competitors may independently develop technology similar to ours. We will continue to seek patent and other intellectual property protections, when appropriate, for those aspects of our technology that we believe constitute innovations providing significant competitive advantages. Our pending, and any future, patent applications may not result in the issuance of valid patents.

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

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

Intellectual property claims may be asserted against us in the future. Intellectual property litigation is expensive and time-consuming and could divert management s attention away from running our business. Intellectual property litigation could also require us to develop non-infringing technology or enter into royalty or license agreements. These royalty or license agreements, if required, may not be available on acceptable terms, if at all. Our failure or inability to develop non-infringing technology or license the proprietary rights on a timely basis would harm our business.

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Research and Development

We believe that our future success will depend in part on our ability to continue to develop new business, and to enhance our existing business. Accordingly, we invest a significant amount of our resources in research and development activities. During each of the fiscal years ended September 30, 2011 and 2010, we spent $3.5 million and $3.1 million, respectively, on internal research and development activities in our business. These amounts represent 14% and 15%, respectively, of total revenue in each of those years.

Employees

At September 30, 2011 and 2010, we had 94 and 90 full-time employees, respectively. 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.

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ITEM 1A. RISK FACTORS

YOU SHOULD CAREFULLY CONSIDER THE RISKS DESCRIBED BELOW BEFORE MAKING AN INVESTMENT DECISION. THE RISKS DESCRIBED BELOW ARE NOT THE ONLY ONES WE FACE. ADDITIONAL RISKS THAT WE ARE NOT PRESENTLY AWARE OF OR THAT WE CURRENTLY BELIEVE ARE IMMATERIAL MAY ALSO IMPAIR OUR BUSINESS OPERATIONS. OUR BUSINESS COULD BE HARMED BY ANY OR ALL OF THESE RISKS. THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE SIGNIFICANTLY DUE TO ANY OF THESE RISKS, AND YOU MAY LOSE ALL OR PART OF YOUR INVESTMENT. IN ASSESSING THESE RISKS, YOU SHOULD ALSO REFER TO THE OTHER INFORMATION CONTAINED OR INCORPORATED BY REFERENCE IN THIS ANNUAL REPORT ON FORM 10-K, INCLUDING OUR CONSOLIDATED FINANCIAL STATEMENTS AND RELATED NOTES.

Economic conditions could materially adversely affect the Company.

The global economic crisis experienced since 2008 and any continuing unfavorable economic conditions have negatively affected, and could continue to negatively affect, our business, operating results or financial condition, which could in turn affect our stock price. Weak economic conditions and the resulting impact on the availability of public funds along with the possibility of state and local budget cuts and reduced university enrollment could lead to a reduction in demand for our products and services. In addition, a prolonged economic downturn could cause insolvency of key suppliers resulting in product delays, inability of customers to obtain credit to finance purchases of the Company s products and inability or delay of our channel partners and other customers to pay accounts receivable owed to us.

Economic conditions may have a disproportionate effect on the sale of our products.

Many of our customers will look at the total A/V equipment and labor cost to outfit a typical conference room or lecture hall as one amount for budgetary purposes. Consequently, although our products represent only a portion of the total cost, the cost of the entire project of outfitting a room or conference hall may be considered excessive and may not survive budgetary constraints. Alternatively, our resellers may modify their quotes to end customers by eliminating our products or substituting less expensive competitive products in order to win opportunities within budget constraints. Event service partners may similarly suggest that customers eliminate recording and webcasting as a means of reducing event cost. Consequently, declines in spending by government, educational or corporate institutions due to budgetary constraints may have a disproportionate impact on the Company and result in a material adverse impact on our financial condition.

Multiple unit deals are needed for continued success.

We need to sell multiple units to educational, corporate and government institutions in order to sell most efficiently and remain profitable. In fiscal 2011, 67% of revenue was to existing customers compared to 70% in fiscal 2010. In particular, sales of multiple units to corporate customers have lagged behind results achieved in the higher education market; consequently, we have allocated more resources to the higher education market. While we have addressed a strategy to leverage existing customers and close multiple unit transactions, a customer may choose not to make expected purchases of our products. The failure of our customers to make expected purchases will harm our business.

Manufacturing disruption or capacity constraints would harm our business.

We subcontract the manufacture of our mobile recorders to one third-party contract manufacturer and subcontract the manufacture of our rack recorder and a proprietary component of our recorders to another third-party contract manufacturer. Although we believe there are multiple sources of supply from other contract manufacturers as well as multiple suppliers of component parts required by the contract manufacturers, a disruption of supply of component parts or completed products, even if short term, would have a negative impact on our revenues. Many component parts currently have long delivery lead times, requiring careful estimation of production requirements. Lengthening lead times, product design changes and other third party manufacturing disruptions have caused delays in delivery. In order to compensate for supply delays, we have sourced components from off-shore sources, used cross

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component parts, paid for expediting and currently hold substantially larger quantities of inventory than in the past. Many of these strategies have increased our costs and may not be sufficient to ensure against production delays. We depend on our subcontract manufacturers to produce our products efficiently while maintaining high levels of quality. Any manufacturing defects, delay in production or changes in product features will likely cause customer dissatisfaction and may harm our reputation. Moreover, any incapacitation of the manufacturing site due to destruction, natural disaster or similar events could result in a loss of product inventory. As a result of any of the foregoing, we may not be able to meet demand for our products, which could negatively affect revenues in the quarter of the disruption or longer depending upon the magnitude of the event, and could harm our reputation.

We may need to raise additional capital.

At September 30, 2011 we had cash of $5.5 million and availability under our line of credit facility with Silicon Valley Bank of $1.9 million. The Company has historically financed its operations primarily through cash from sales of equity securities, cash from operations, and to a limited extent, through bank credit facilities. The Company has a history of operating losses prior to fiscal 2011 and historically used cash in operations prior to fiscal 2010. The Company improved both metrics with a combination of increased revenue and expense reductions over the last three fiscal years and while we expect to continue to increase revenue in fiscal 2012, we also anticipate investing more significantly in engineering and marketing resources and therefore increasing operating expenses. The Company believes such investments will lead to greater revenue growth in future years but there can be no assurance that our strategy will have such an effect on a timely basis, or at all. The Company believes its cash position and available credit is adequate to accomplish its business plan through at least the next twelve months.

We may evaluate further operating or capital lease opportunities or draw on our term debt facility with Silicon Valley Bank to finance equipment purchases in the future and may utilize the Company s revolving line of credit or term facility to support working capital needs. While the Company anticipates that it will be in compliance with all provisions of our debt facilities, there can be no assurance that the existing debt facilities will be available to the Company or that additional financing will be available or on terms acceptable to the Company.

The business environment is not currently conducive to raising additional debt or equity financing and may not improve in the near term. If we borrow money, we may incur significant interest charges, which could harm our profitability. Holders of debt would also have rights, preferences or privileges senior to those of existing holders of our common stock. If we raise additional equity, the terms of such financing may dilute the ownership interests of current investors and cause our stock price to fall significantly. We may not be able to secure financing upon acceptable terms, if at all. If we cannot raise funds on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could seriously harm our business, operating results, and financial condition

We have only recently achieved profitability.

While we reached profitability in two quarters of fiscal 2011 and generated cash from operations of $1.4 million, we may not realize sufficient revenues to sustain profitability on a quarterly or annual basis. For the year ended September 30, 2011, we had a gross margin of $17.9 million on revenue of $25.2 million with which to cover selling, marketing, product development and general and administrative costs. Our selling, marketing, product development and general and administration costs have historically been a significant percentage of our revenue, due partly to the expense of developing leads and the relatively long period required to convert leads into sales associated with selling products that are not yet considered mainstream technology investments. Fluctuations in profitability or failure to maintain profitability will likely impact the price of our stock.

We could lose revenues if there are changes in the spending policies or budget priorities for government funding of colleges, universities, schools and other education providers.

Most of our customers and potential customers are public colleges, universities, schools and other education providers who depend substantially on government funding. Accordingly, any general decrease, delay or change in federal, state or local funding for colleges, universities, schools and other education providers could cause our current and potential

customers to reduce their purchases of our products and services, or to decide not to renew service contracts, either of which could cause us to lose revenues. In addition, a specific reduction in governmental funding support for products such as ours would also cause us to lose revenues. The severe economic downturn experienced in the U.S. and globally has caused many of our clients to experience severe budgetary pressures, which has and will likely continue to have a negative impact on sales of our products. Continuing unfavorable economic conditions may result in further budget cuts and lead to lower overall spending, including information technology spending, by our current and potential clients, which may cause our revenues to decrease.

If a sufficient number of customers do not accept our products, our business may not succeed.

We cannot predict how the market for our products will develop, and part of our strategic challenge will be to convince enterprise customers of the productivity, improved communications, cost savings, suitability and other benefits of our products. Our future revenue and revenue growth rates will depend in large part on our success in delivering these products effectively, creating market acceptance for these products and meeting customer s needs for new or enhanced products. If we fail to do so, our products will not achieve widespread market acceptance, and we may not generate sufficient revenue to offset our product development and selling and marketing costs, which will hurt our business.

We may not be able to innovate to meet the needs of our target market.

Our future success will continue to depend upon our ability to develop new products, product enhancements or service offerings that address future needs of our target markets and to respond to these changing standards and practices. The success of new products, product enhancements or service offerings depend on several factors, including the timely completion, quality and market acceptance of the product, enhancement or service. Our revenue could be reduced if we do not capitalize on our current market leadership by timely developing innovative new products, product enhancements or service offerings that will increase the likelihood that our products and services will be accepted in preference to the products and services of our current and future competitors.

If our marketing and lead generation efforts are not successful, our business will be harmed.

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

The length of our sales and deployment cycle is uncertain, which may cause our revenue 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 revenue. Our expense levels are relatively fixed in the short-term and based in part on our expectations of future revenue. 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 revenue.

Our largest potential sources of revenue are educational institutions, large corporations and government entities that often require long testing and approval processes before making a decision to purchase our products, particularly when evaluating our products for inclusion in new buildings under construction or high dollar transactions. In general, the process of selling our products to a potential customer may involve lengthy negotiations, collaborations with consultants, designers and architects, time consuming installation processes and changes in network infrastructure in excess of what we or our VARs are able to provide. As a result, our sales cycle is unpredictable. Our sales cycle is also 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, particularly with customers or potential customers that rely on government funding.

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

Sales of some of our products have experienced seasonal fluctuations which have affected sequential growth rates for these products, particularly in our first fiscal quarter. For example, there is generally a slowdown for sales of our products in the higher education and corporate markets in the first fiscal quarter of each year. Seasonal fluctuations could negatively affect our business, which could cause our operating results to fall short of anticipated results for such quarters. As such, we believe that quarter-to-quarter comparisons of our revenues, operating results and cash flows may not be meaningful and should not be relied upon as an indication of future performance.

Our operating results are hard to predict as a significant amount of our sales typically occur at the end of a quarter and the mix of product and service orders may vary significantly.

Revenue for any particular quarter is extremely difficult to predict with any degree of certainty. We typically ship products within a short time after we receive an order and therefore, we typically do not have an order backlog with which to estimate future revenue. In addition, orders from our channel partners are based on the level of demand from end-user customers. Any decline or uncertainty in end-user demand could negatively impact end-user orders, which could in turn significantly negatively affect orders from our channel partners in any given quarter. Accordingly, our expectations for both short and long-term future revenue is based almost exclusively on our own estimate of future demand based on the pipeline of sales opportunities we manage, rather than on firm channel partner orders. Our expense levels are based largely on these estimates. In addition, the majority of our orders are received in the last month of a quarter; thus, the unpredictability of the receipt of these orders could negatively impact our future results. We historically have received all or nearly all our channel partner orders in the last month of a quarter and often in the last few days of the quarter. Accordingly, any significant shortfall in demand for our products in relation to our expectations, even if the result was a short term delay in orders, would have an adverse impact on our operating results.

We have experienced growing demand for our hosting and event services as well as a growing preference from our corporate customers in purchasing our software as a service (SaaS). As a result, we expect that service billings as a percentage of total billings will continue to grow which we believe will ultimately lead to more recurring revenue. We subcontract for some services required by our events customers, such as close captioning, and charge for such services at a lower margin than other services. The percentage of billings represented by services, provided either directly or indirectly, is also likely to fluctuate from quarter to quarter due to seasonality of event services and other factors. Since services are typically billed in advance of providing the service, revenue is initially deferred, leading to reduced current period revenue with a corresponding negative impact to profits or losses in periods of significant increase in the percentage of our billings for deferred services.

We are subject to risks associated with our channel partners product inventories and product sell-through.

We sell a significant amount of our products to distributors such as Synnex Corporation and Starin Marketing, Inc., as well as other channel partners who maintain their own inventory of our products for sale to dealers and end-users. If these channel partners are unable to sell an adequate amount of their inventory of our products in a given quarter to dealers and end-users or if channel partners decide to decrease their inventories for any reason, such as a long-term continuation or increase, in global economic uncertainty and downturn in technology spending, the volume of our sales to these channel partners and our revenue would be negatively affected. In addition, if channel partners decide to purchase more inventory, due to product availability or other reasons, than is required to satisfy end-user demand or if end-user demand does not keep pace with the additional inventory purchases, channel inventory could grow in any particular quarter, which could adversely affect product revenue in the subsequent quarter. In addition,

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we also face the risk that some of our channel partners have inventory levels in excess of future anticipated sales. If such sales do not occur in the time frame anticipated by these channel partners for any reason, these channel partners may substantially decrease the amount of product they order from us in subsequent periods, which would harm our business.

If stock balancing returns or price adjustments exceed our reserves, our operating results could be adversely affected.

We provide some of our distributors with stock balancing return rights, which generally permit our distributors to return products, subject to ordering an equal dollar amount of alternate products. We also provide price protection rights to most of our distributors. Price protection rights require that we grant retroactive price adjustments for inventories of our products held by distributors if we lower our prices for those products within a specified time period. To cover our exposure to these product returns and price adjustments, we establish reserves based on our evaluation of historical product trends and current marketing plans. However, we cannot be assured that our reserves will be sufficient to cover our future product returns and price adjustments. If we inadequately forecast reserves, our operating results could be adversely affected.

We depend in part on the success of our relationships with third-party resellers and integrators.

Our success depends on various third-party relationships, particularly with our international and events services operations. The relationships include third party resellers as well as system integrators that assist with implementations of our products and sourcing of our products and services. Identifying partners, negotiating and documenting relationships with them and maintaining their relationships require significant time and resources from us. In addition, our agreements with our resellers and integrators are typically non-exclusive and do not prohibit them from working with our competitors or from offering competing products or services. We have limited control, if any, as to whether these strategic partners devote adequate resources to promoting, selling and implementing our products as compared to our competitor s products. Our competitors may be effective in providing incentives to third parties to favor their products or services. If we are unsuccessful in establishing or maintaining our relationships with these third parties, our ability to compete in the marketplace or to maintain or grow our revenue could be impaired and our operating results would suffer.

Our cash flow could fluctuate due to the potential difficulty of collecting our receivables.

A significant portion of our sales are fulfilled by VARs, regional distributors or master distributors. As an example, 50% of our billings in 2011 were to Synnex Corporation and Starin Marketing Inc., two master distributors who fulfill demand from other distributors, VARs or end-users. While our distributors and VARs typically maintain payment terms consistent with other end-users, a delay in payment may occur as a result of a number of factors including changes in demand, general economic factors, financial performance, inventory levels or disputes over payments. Any delay from Synnex, Starin, or other large distributors or VARs, could have a material impact on the collections of our receivables during a particular quarter.

We have recently expanded the level of sales representation in Europe and Asia as well as other international regions. We offer credit terms to some of our international customers; however, payments tend to go beyond terms in certain countries and advances allowable on accounts receivable from international customers under our revolving line of credit are calculated using a lower advance rate than domestic receivables and are limited to $500 thousand. Therefore, as Europe, Asia and other international regions grow, accounts receivable balances will likely increase as compared to previous years and our ability to finance the increase will be limited.

Accounting regulations and related interpretations and policies, particularly those related to revenue recognition, cause us to defer revenue recognition into future periods for portions of our products and services.

Revenue recognition for our products and services is complex and subject to multiple sources of authoritative guidance, some of which are new, as well as varied interpretations and implementation practices for such rules. These rules require us to apply judgment in determining revenue recognition in certain situations. Factors that are considered in revenue recognition include those such as vendor specific objective evidence (VSOE), best estimate of

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selling price and the inclusion of other services and contingencies to payment terms. We expect that we will continue to defer portions of our service billings because of these factors, and to the extent that management s judgment is incorrect it could result in an increase in the amount of revenue deferred in any one period. The amounts deferred may also be significant and may vary from quarter to quarter depending on the mix of products sold or contractual terms.

Additional changes in authoritative guidance or changes in practice in applying such rules could also cause us to defer the recognition of revenue to future periods or recognize lower revenue.

Because most of our service contracts are renewable on an annual basis, a reduction in our service renewal rate could significantly reduce our revenues.

Our clients have no obligation to renew their content hosting agreements, customer support contracts or other annual service contracts after the expiration of the initial period, which is typically one year, and some clients have elected not to do so. A decline in renewal rates could cause our revenues to decline. We have limited historical data with respect to rates of renewals, so we cannot accurately predict future renewal rates. Our renewal rates may decline or fluctuate as a result of a number of factors, including client dissatisfaction with our products and services, our failure to update our products to maintain their attractiveness in the market, deteriorating economic conditions or budgetary constraints or changes in budget priorities faced by our clients.

Because we generally recognize revenues ratably over the term of our service contracts, downturns or upturns in service transactions will not be fully reflected in our operating results until future periods.

We recognize most of our revenues from service contracts monthly over the terms of their agreements, which are typically 12 months, although terms have ranged from less than one month to 48 months. As a result, much of the service revenue we report in each quarter is attributable to agreements entered into during previous quarters. Consequently, a decline in sales, client renewals or market acceptance of our products in any one quarter will not necessarily be fully reflected in the revenues in that quarter and will negatively affect our revenues and profitability in future quarters. This ratable revenue recognition also makes it difficult for us to rapidly increase our revenues through additional sales in any period, as revenues from new clients must be recognized over the applicable agreement term.

There is a great deal of competition in the market for our products, which could lower the demand for our products.

The market for our products and services is intensely competitive, dynamic and subject to rapid technological change. The intensity of the competition and the pace of change are expected to increase in the future. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any one of which could seriously harm our business. Competitors vary in size and in the scope and breadth of the products and services offered, many of which have greater financial resources than we have. We encounter competition with respect to different aspects of our solution from a variety of sources including:

Web conferencing solutions (e.g. Adobe, Cisco/WebEx, Microsoft and Citrix). Although part of the overall online multimedia communications landscape, these solutions are designed primarily for collaborative communications versus one-to-many communications like Mediasite. Many organizations acknowledge that they need both technologies one-to-many webcasting and collaborative web conferencing to appropriately address their different communication requirements.

Video conferencing solutions (e.g. Polycom, TANDBERG (now Cisco) and Sony). These solutions are designed primarily for one-to-one or group-to-group communications with high levels of interactivity and collaboration. Like web conferencing, many organizations use both video conferencing and webcasting. Mediasite integrates with videoconferencing endpoints from Polycom and TANDBERG to record and manage interactive meetings, discussions and distance learning courses alongside other Mediasite content.

Authoring tools solutions (e.g. Polycom Accordent PresenterPLUS and TechSmith Camtasia). Unlike webcasting, web conferencing or video conferencing, which are forms of online multimedia communication that capture and distribute/stream content, these solutions are production-oriented tools designed to create and edit multimedia

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content only. Some organizations will use these desktop tools to create training content by manually integrating existing audio, video, images, branding and other visual elements into a multimedia presentation which can then be published to a web or streaming server for distribution. This process can require a significant amount of production effort and user expertise in presentation authoring. Mediasite is capable of ingesting content produced by popular desktop tools like TechSmith s Camtasia Relay or in video formats like Windows Media or H.264, allowing the content to be delivered, managed and secured alongside all other Mediasite content.

Online video services and virtual meeting platforms (e.g.INXPO, Livestream, ON24, Onstream Media, InterCall, Thomson Reuters, Unisfair and Wall Street Webcasting). These companies offer services or SaaS-based platforms that either allow audio and video to be captured from a presenter s computer (often with supporting materials uploaded in advance), produced streaming video services or 2D/3D virtual environments that may or may not include rich media webcasts.

Other vendors such as Echo360, Tegrity, Panopto, TechSmith, Crestron and Accordent Technologies (now Polycom), provide lecture capture or webcasting capabilities, but differ in their technology approach, particularly in the lecture capture arena. Mediasite is an appliance- or room-based platform for lecture capture. It provides a fully integrated system designed around an automated purpose-built recording appliance to capture, publish and manage rich media content. This transparent recording automation means no presenter intervention which leads to the broadest end-user adoption across campuses. Room-based appliances are capable of streaming live or on-demand and can leverage the full breadth of in-room audio/visual technology. A room-based platform like Mediasite also includes complete content management for captured multimedia presentations.

Other lecture capture solutions are implemented as software applications designed to capture and publish rich media content from a desktop. Such solutions can be used to create and distribute content in advance of a lecture, and are dependent upon a third-party content management platform, typically the institution s course management system. Software applications for lecture capture support on-demand streaming only and require PC integration with varying levels of presenter intervention and recording knowledge but contain certain features some of our potential customers require.

Lastly, laptop-resident desktop tools capture and publish non-rich media (limited video and presentation graphics) and like software applications support only on-demand streaming and require a third-party content management platform. Desktop tools require the greatest degree of presenter intervention, technical confidence and support. Laptop-resident desktop tools are prevalent on many campuses.

If potential customers or competitors use open source software to develop products that are competitive with our products and services, we may face decreased demand and pressure to reduce the prices for our products.

The growing acceptance and prevalence of open source software may make it easier for competitors or potential competitors to develop software applications that compete with our products, or for customers and potential customers to internally develop software applications that they would otherwise have licensed from us. One of the aspects of open source software is that it can be modified or used to develop new software that competes with proprietary software applications, such as ours. Such competition can develop without the degree of overhead and lead time required by traditional proprietary software companies. As open source offerings become more prevalent, customers may defer or forego purchases of our products, which could reduce our sales and lengthen the sales cycle for our products or result in the loss of current customers to open source solutions. If we are unable to differentiate our products from competitive products based on open source software, demand for our products and services may decline, and we may face pressure to reduce the prices of our products, which would hurt our profitability.

Our customers may use our products to share confidential and sensitive information, and if our system security is breached, our reputation could be harmed and we may lose customers.

Our customers may use our products and services to share confidential and sensitive information, the security of which is critical to their business. Third parties may attempt to breach our security for customer hosted content or the networks of our customers. Customers may take inadequate security precautions with their sensitive information and may inadvertently make that information public. We may be liable to our customers for any breach in security, and any breach could harm our reputation and cause us to lose customers. In addition, customers are vulnerable to

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computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays or loss of data. We may be required to expend significant capital and other resources to further protect against security breaches or to resolve problems caused by any breach, including litigation-related expenses if we are sued.

Operational failures in our network infrastructure could disrupt our remote hosting services, cause us to lose clients and sales to potential clients and result in increased expenses and reduced revenues.

Unanticipated problems affecting our network systems could cause interruptions or delays in the delivery of the hosting services we provide to some of our clients. We are not equipped to provide full disaster recovery to all of our hosted clients. If there are operational failures in our network infrastructure that cause interruptions, slower response times, loss of data or extended loss of service for our remotely hosted clients, we may be required to issue credits or pay penalties, current clients may terminate their contracts or elect not to renew them and we may lose sales to potential clients. We have recently acquired additional hardware and systems and outsourced most aspects of our network infrastructure to two providers. As a result, we are reliant on third parties for network availability so outages may be outside our control and we may need to acquire additional hardware in order to provide an appropriate level of redundancy required by our customers.

We license technology from third parties. If we are unable to maintain these licenses, our operations and financial condition may be negatively impacted.

We license technology from third parties. The loss of, our inability to maintain, or changes in material terms of these licenses could result in increased cost or delayed sales of our software and services, or may cause us to remove features from our products or services. We anticipate that we will continue to license technology from third parties in the future. This technology may not continue to be available on commercially reasonable terms, if at all. Although we do not believe that we are substantially dependent on any individual licensed technology, some of the component technologies that we license from third parties could be difficult for us to replace. The impairment of these third-party relationships, especially if this impairment were to occur in unison, could result in delays in the delivery of our software and services until equivalent technology, if available, is identified, licensed and integrated. This delay could adversely affect our operating results and financial condition.

The technology underlying our products and services is complex and may contain unknown defects that could harm our reputation, result in product liability or decrease market acceptance of our products.

The technology underlying our products is complex and includes software that is internally developed, software licensed from third parties and hardware purchased from third parties. These products have, and will in the future, 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 and our insurance coverage may not be sufficient to cover our complete liability exposure. Any defects in our products and services could:

- Damage our reputation
- Cause our customers to initiate product liability suits against us
- Increase our product development resources

Cause customers to cancel orders or potential customers to purchase competitive products or services

Delay market acceptance of our products

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If we are viewed only as a commodity supplier, our margins and valuations will shrink.

We need to provide value-added services in order to avoid being viewed as a commodity supplier. This entails building long-term customer relationships and developing features that will distinguish our products. Our technology is complex and is often confused with other products and technologies in the market place, including video conferencing, streaming and collaboration.

We may develop lower cost solutions to certain of our products in order to address certain market segments. Such products, if implemented, would have more limited features compared to our existing products. While we believe we can preserve the market for our full-featured products, release of lower cost products could reduce demand for products sold at higher prices.

If we fail to build long-term customer relationships and develop features that distinguish our products in the market place, our margins will shrink and our stock may become less valuable to investors.

Our success depends upon the proprietary aspects of our technology.

Our success and ability to compete depend to a significant degree upon the protection of our proprietary technology. We currently have four U.S. patents that have been issued to us and one U.S. patent applications that are pending. We may seek additional patents in the future. Our current patent applications cover different aspects of the technology used in our products which is important to our ability to compete. However, it is possible that:

- Our pending patent applications may not result in the issuance of patents
- Any patents acquired by or issued to us may not be broad enough to protect us
- Any issued patent could be successfully challenged by one or more third parties, which could result in our loss of the right to prevent others from exploiting the inventions claimed in those patents
- Current and future competitors may independently develop similar technology, duplicate our services or design around any of our patents
- Effective patent protection, including effective legal-enforcement mechanisms against those who violate our patent-related assets, may not be available in every country in which we do or plan to do business
- We may not have the resources to enforce our patents or may determine the potential benefits are not worth the cost and risk of ultimately being unsuccessful

We also rely upon trademark, copyright and trade secret laws, which may not be sufficient to protect our intellectual property.

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

Third parties may infringe or misappropriate our copyrights, trademarks and similar proprietary rights

Laws and contractual restrictions may not be sufficient to prevent misappropriation of our technology or to deter others from developing similar technologies

Effective trademark, copyright and trade secret protection, including effective legal-enforcement mechanisms against those who violate our trademark, copyright or trade secret assets, may be unavailable or limited in foreign countries

Contractual agreements may not provide meaningful protection for our trade secrets, know-how or other proprietary information in the event of any unauthorized use, misappropriation or disclosure of such trade secrets, know-how or other proprietary information

Other companies may claim common law trademark rights based upon state or foreign laws that precede the federal registration of our marks

Policing unauthorized use of our services and trademarks is difficult, expensive and time-consuming, and we may be unable to determine the extent of any unauthorized use Reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third parties to benefit from our technology without paying us for it, which would significantly harm our business.

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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 legal proceedings, 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, which could harm our business.

If we lose key personnel or fail to integrate replacement personnel successfully, our ability to manage our business could be impaired.

Our future success depends upon the continued service of our key management, technical, sales and other critical personnel. Our officers and other key personnel are employees-at-will, and we cannot assure that we will be able to retain them. Key personnel have left our company in the past, sometimes to accept employment with companies that sell similar products or services to existing or potential customers of ours. There will likely be additional departures of key personnel from time to time in the future and such departures could result in additional competition, loss of customers or confusion in the marketplace. As we seek to replace such departures, or expand our business, the hiring of qualified sales, technical and support personnel has been difficult due to the limited number of qualified professionals. The loss of any key employee could result in significant disruptions to our operations, including adversely affecting the timeliness of product releases, the successful implementation and completion of company initiatives and the results of our operations. In addition, we do not have life insurance policies on any of our key employees. If we lose the services of any of our key employees, the integration of replacement personnel could be time consuming, may cause disruptions to our operations and may be unsuccessful.

Because our business is susceptible to risks associated with international operations, we may not be able to maintain or increase international sales of our products.

International product and service billings ranged from 19% to 28% of our total billings in each of the past three years and are expected to continue to account for a significant portion of our business in the future. However, in the future we may be unable to maintain or increase international sales of our products and services. International sales are subject to a variety of risks, including:

- difficulties in establishing and managing international distribution channels;
- difficulties in selling, servicing and supporting overseas products, translating products into foreign languages and compliance with local hardware requirements;
- the uncertainty of laws and enforcement in certain countries relating to the protection of intellectual property or requirements for product certification or other restrictions;
- multiple and possibly overlapping tax structures;
- currency and exchange rate fluctuations;

difficulties in collecting accounts receivable in foreign countries, including complexities in documenting letters of credit; and

economic or political changes in international markets.

We face risks associated with government regulation of the internet and related legal uncertainties.

Currently, few existing laws or regulations specifically apply to the Internet, other than laws generally applicable to businesses. Many Internet-related laws and regulations, however, are pending and may be adopted in the United States, in individual states and local jurisdictions and in other countries. These laws may relate to many areas that impact our business, including encryption, network and information security, and the convergence of traditional

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communication services, such as telephone services, with Internet communications, taxes and wireless networks. These types of regulations could differ between countries and other political and geographic divisions both inside and outside the United States. Non-U.S. countries and political organizations may impose, or favor, more and different regulation than that which has been proposed in the United States, thus furthering the complexity of regulation. In addition, state and local governments within the United States may impose regulations in addition to, inconsistent with, or more strict than federal regulations. The adoption of such laws or regulations, and uncertainties associated with their validity, interpretation, applicability and enforcement, may affect the available distribution channels for, and the costs associated with, our products and services. The adoption of such laws and regulations may harm our business.

The large number of shares eligible for future sale may adversely affect the market price of our common stock.

With the departure of two of our former officers, there is a substantial number of shares of common stock that could be for sale in the public market which could materially adversely affect the market price of our common stock and impair our ability to raise capital through the sale of our equity securities. Our founder and former Chief Technology Officer left the Company on March 31, 2011 and is no longer subject to restrictions on affiliate sales of common stock under Rule 144 of the Securities Act of 1933(Rule 144). Similarly, our former Executive Chairman left the Company on September 30, 2011 and will no longer be subject to restrictions on affiliate sales of common stock under Rule 144 as of December 29, 2011. The Company believes the two individuals hold or control approximately 300,000 shares of our common stock which is or will be saleable without regard to volume or other restrictions under Rule 144. Such former affiliates could sell their shares on the public market in volume levels that could adversely affect the price of our common 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 of our common stock.

At September 30, 2011, we had 2 thousand of outstanding warrants and 786 thousand of outstanding stock options granted under our stock option plans, 536 thousand of which are immediately exercisable.

To the extent that these stock options or warrants are exercised, 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. Exercises of these options or warrants, or even the potential of their exercise may have an adverse effect on the trading price of our common stock. The holders of our options or our warrants are likely to exercise them at times when the market price of the common stock exceeds the exercise price of the securities. Accordingly, the issuance of shares of common stock upon exercise of the options and warrants will likely result in dilution of the equity represented by the then outstanding shares of common stock held by other stockholders. Holders of our options and warrants can be expected to exercise or convert them at a time when we would, in all likelihood, be able to obtain any needed capital on terms, which are more favorable to us than the exercise terms provided, by these options and warrants.

We may need to make acquisitions or form strategic alliances or partnerships in order to remain competitive in our market, and potential future acquisitions, strategic alliances or partnerships could be difficult to integrate, disrupt our business and dilute stockholder value.

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

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Our ability to utilize our net operating loss carryforwards may be limited.

The use of our net operating loss carryforwards may have limitations resulting from certain future ownership changes or other factors under Section 382 of the Internal Revenue Code.

If our net operating loss carryforwards are limited, and we have taxable income which exceeds the available net operating loss carryforwards for that period, we would incur an income tax liability even though net operating loss carryforwards may be available in future years prior to their expiration. Any such income tax liability may adversely affect our future cash flow, financial position and financial results.

Our business is subject to changing regulations regarding corporate governance and public disclosure that will increase both our costs and the risk of noncompliance.

As a publicly traded company we are subject to significant regulations, including the Sarbanes-Oxley Act of 2002. While we have developed and instituted a corporate compliance program based on what we believe are the current best practices and continue to update the program in response to newly implemented regulatory requirements and guidance, we cannot assure that we are or will be in compliance with all potentially applicable regulations. Although our non-affiliate market capitalization was less than $75 million at March 31, 2011 and we were therefore not required to have an auditor attestation on our internal controls over financial reporting for fiscal 2011, SEC rules may in the future require us to have such an attestation if our non-affiliate market capitalization exceeds a certain threshold. We cannot assure that in the future our management or our auditors, will not find a material weakness in connection with our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act. We also cannot assure that we could correct any such weakness to allow our management to assess the effectiveness of our internal control over financial reporting as of the end of our fiscal year in time to enable our independent registered public accounting firm to attest that such assessment will have been fairly stated in our Annual Report on Form 10-K to be filed with the Securities and Exchange Commission or attest that we have maintained effective internal control over financial reporting as of the end of our fiscal year. If we fail to comply with any of these regulations, we could be subject to a range of regulatory actions, fines, or other sanctions or litigation. In addition, if we must disclose any material weakness in our internal control over financial reporting, our stock price may decline.

Provisions of our charter documents and Maryland law could also discourage an acquisition of our company that would benefit our stockholders.

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

Because our business is susceptible to risks associated with international operations, we may not be able to maintain or increase international sales of our products.

International product and service billings ranged from 19% to 28% of our total billings in each of the past three years and are expected to continue to account for a significant portion of our business in the future. However, in the future we may be unable to maintain or increase international sales of our products and services. International sales are subject to a variety of risks, including:

- difficulties in establishing and managing international distribution channels;

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- difficulties in selling, servicing and supporting overseas products, translating products into foreign languages and compliance with local hardware requirements;
- the uncertainty of laws and enforcement in certain countries relating to the protection of intellectual property or requirements for product certification or other restrictions;
- multiple and possibly overlapping tax structures;
- currency and exchange rate fluctuations;
- difficulties in collecting accounts receivable in foreign countries, including complexities in documenting letters of credit; and
- economic or political changes in international markets.

We face risks associated with government regulation of the internet and related legal uncertainties.

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

Our principal office is located in Madison, Wisconsin in a leased facility of approximately 21,000 square feet. The building serves as our corporate headquarters, accommodating our general and administrative, product development and selling and marketing departments. We believe this facility is adequate and suitable for our needs. The current lease term for this office expires on September 30, 2018.

ITEM 3. LEGAL PROCEEDINGS

None

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PART II

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

Our common stock was initially traded on the American Stock Exchange under the symbol SFO, beginning with our initial public offering in April of 1998. On April 24, 2000, our common stock began trading on the NASDAQ Global Market under the symbol SOFO. Effective September 16, 2009, we transferred the listing of our common stock to the NASDAQ Capital Market. 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 Global or Capital Markets. All share and per share data have been adjusted for the one-for-ten reverse stock split which was effective on November 16, 2009.

	High	Low
Year Ended September 30, 2012:		
First Quarter (through November 17, 2011)	$ 9.87	$ 8.50
Year Ended September 30, 2011:		
First Quarter	15.94	10.10
Second Quarter	15.90	13.45
Third Quarter	15.39	12.38
Fourth Quarter	13.47	8.68
Year Ended September 30, 2010:		
First Quarter	7.50	4.50
Second Quarter	8.21	4.80
Third Quarter	7.99	5.84
Fourth Quarter	11.12	6.81

The Company has not paid any cash dividends and does not intend to pay any cash dividends in the foreseeable future. The Company is prohibited from paying any cash dividends pursuant to the terms of the loan and security agreement with Silicon Valley Bank.

At November 17, 2011 there were 429 common stockholders of record and approximately 6,000 total shareholders. 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 (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance (c)
Equity compensation plans approved by security holders (1)	635,835	11.70	158,883
Equity compensation plans not approved by security holders (2)	149,712	10.74	
Total	785,547	11.52	158,883

(1) Consists of the 2009 Stock Incentive Plan, Employee Incentive Stock Option Plan and the Directors Stock Option Plans. For further information regarding these plans, reference is made to Note 5 of the financial statements.

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

The graph below compares the cumulative total stockholder return on our common stock from September 30, 2006 through and including September 30, 2011 with the cumulative total return on The NASDAQ Stock Market (US only) and the RDG Technology Composite. The graph assumes that $100 was invested in our common stock on September 30, 2006 for each of the indexes and that all dividends were reinvested. Unless otherwise specified, all dates refer to the last day of each month presented. The comparisons in the graph below are based on historical data, with our common stock prices based on the closing price on the dates indicated, and are not intended to forecast the possible future performance of our common stock.

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(A) RECENT SALES OF UNREGISTERED SECURITIES

None

(B) USE OF PROCEEDS FROM REGISTERED SECURITIES

None

(C) ISSUER PURCHASES OF EQUITY SECURITIES

None

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ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The selected financial and operating data were derived from our consolidated financial statements. 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). All share and per share data have been adjusted for the one-for-ten reverse stock split which was effective on November 16, 2009.

	Years Ended September 30,				
	2011	2010	2009	2008	2007
Statement of Operations Data:					
Revenue	$ 25,222	$ 20,476	$ 18,577	$ 15,601	$ 16,737
Cost of revenue	7,311	5,065	4,331	4,205	4,133
Gross margin	17,911	15,411	14,246	11,396	12,604
Operating expenses	17,633	15,138	16,724	19,279	19,222
Income (loss) from operations	278	273	(2,478)	(7,883)	(6,618)
Other income (expense), net	(310)	(170)	(25)	10	248
Provision for income taxes	(211)	(225)	(142)	(256)	(201)
Net loss	$ (243)	$ (122)	$ (2,645)	$ (8,129)	$ (6,571)
Basic net loss per common share	$ (0.06)	$ (0.03)	$ (0.74)	$ (2.28)	$ (1.89)
Diluted net loss per common share	$ (0.06)	$ (0.03)	$ (0.74)	$ (2.28)	$ (1.89)
Weighted average common shares: - Basic	3,748,840	3,617,423	3,598,040	3,557,966	3,468,803
- Diluted	3,748,840	3,617,423	3,598,040	3,557,966	3,468,803

	2011	2010	2009	2008	2007
Balance Sheet Data at September 30:					
Cash and cash equivalents	$ 5,515	$ 3,358	$ 2,598	$ 3,560	$ 8,008
Working capital	3,083	1,442	(344)	774	7,940
Total assets	21,840	18,267	16,173	17,474	23,981
Long-term liabilities	3,072	3,202	1,977	1,610	1,825
Stockholders equity	9,261	7,137	6,601	8,455	15,908

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

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

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

Overview

Sonic Foundry, Inc. is a technology leader in the emerging web communications marketplace, providing enterprise solutions and services that link an information-driven world. The company s principal product line, Mediasite® is a web communication and content management system that automatically and cost-effectively webcasts lectures and presentations. Trusted by Fortune 500 companies, top education institutions and Federal, state and local government agencies for a variety of critical communication needs, Mediasite is the leading one-to-many multimedia communication solution for capturing knowledge and sharing it online.

Reverse Stock Split

Effective November 16, 2009, the Company implemented a one-for-ten reverse stock split of its stock. All shares and per share data in this report have been adjusted to reflect this reverse stock split.

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, allowance for doubtful accounts, and reserves;
- Impairment of long-lived assets;

Valuation allowance for net deferred tax assets; and

Accounting for stock-based compensation.

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Revenue Recognition, Allowance for Doubtful Accounts and Reserves

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 collectability is reasonably assured. Revenue is deferred when undelivered products or services are essential to the functionality of delivered products, customer acceptance is uncertain, significant obligations remain, or the fair value of undelivered elements is unknown. The Company does not offer customers the right to return product, other than for exchange or repair pursuant to a warranty or stock rotation. The Company s policy is to reduce revenue if it incurs an obligation for price rebates or other such programs during the period the obligation is reasonably estimated to occur. The following policies apply to the Company s major categories of revenue transactions.

Products

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

Services

The Company sells support and content hosting contracts to our customers, typically one year in length, and records 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 distribution partners, software upgrades on a when and if available basis, advance hardware replacement and an extension of the standard hardware warranty from 90 days to one year. The manufacturers we contract with to build the units provide a limited one-year warranty on the hardware. We also sell installation, training, event webcasting, and customer content hosting services. Revenue for those services is recognized when performed in the case of installation, training and event webcasting services and is recognized ratably over the contract period when these additional elements are sold with hosting. Service amounts invoiced to customers in excess of revenue recognized are recorded as deferred revenue until the revenue recognition criteria are met.

Revenue Arrangements that Include Multiple Elements

The Company has historically applied the software revenue recognition rules as prescribed by Accounting Standards Codification (ASC) Subtopic 985-605. In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) Number 2009-14, Certain Revenue Arrangements That Include Software Elements, which amended ASC Subtopic 985-605. This ASU removes tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of the software revenue recognition rules. In the case of the Company s hardware products with embedded software, the Company has determined that the hardware and software components function together to deliver the product s essential functionality, and therefore, the revenue from the sale of these products no longer falls within the scope of the software revenue recognition rules. Revenue from the sale of software-only products remains within the scope of the software revenue recognition rules. Installation, training, and post customer support no longer fall within the scope of the software revenue recognition rules, except when they are sold with and relate to a software-only product. Revenue recognition for products that no longer fall under the scope of the software revenue recognition rules is similar to that for other tangible products. ASU Number 2009-13, Multiple-Deliverable Revenue Arrangements, which amended ASC Topic 605 and was also issued in October 2009, is applicable for multiple-deliverable revenue arrangements. ASU 2009-13 allows companies to allocate revenue in a multiple-deliverable arrangement in a manner that better reflects the transaction s economics. ASU 2009-13 and 2009-14 were adopted and are effective for revenue arrangements entered into or materially modified in the Company s fiscal year 2011.

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Under the software revenue recognition rules, the fee from a multiple-deliverable arrangement is allocated to each of the undelivered elements based upon vendor-specific objective evidence (VSOE), which is limited to the price charged when the same deliverable is sold separately, with the residual value from the arrangement allocated to the delivered element. The portion of the fee that is allocated to each deliverable is then recognized as revenue when the criteria for revenue recognition are met with respect to that deliverable. If VSOE does not exist for all of the undelivered elements, then all revenue from the arrangement is typically deferred until all elements have been delivered to the customer. All revenue arrangements, with the exception of hosting contracts, entered into prior to October 1, 2010 and the sale of all software-only products and associated services have been accounted for under this guidance during the year ended September 30, 2011.

Under the revenue recognition rules for tangible products as amended by ASU 2009-13, the fee from a multiple-deliverable arrangement is allocated to each of the deliverables based upon their relative selling prices as determined by a selling-price hierarchy. A deliverable in an arrangement qualifies as a separate unit of accounting if the delivered item has value to the customer on a stand-alone basis. A delivered item that does not qualify as a separate unit of accounting is combined with the other undelivered items in the arrangement and revenue is recognized for those combined deliverables as a single unit of accounting. The selling price used for each deliverable is based upon VSOE if available, third-party evidence (TPE) if VSOE is not available, and best estimate of selling price (ESP) if neither VSOE nor TPE are available. TPE is the price of the Company s or any competitor s largely interchangeable products or services in stand-alone sales to similarly situated customers. ESP is the price at which the Company would sell the deliverable if it were sold regularly on a stand-alone basis, considering market conditions and entity-specific factors. All revenue arrangements negotiated after September 30, 2010, excluding the sale of all software-only products and associated services, have been accounted for under this guidance during the year ended September 30, 2011.

The selling prices used in the relative selling price allocation method are as follows: (1) for the Company s products and certain services are based upon VSOE, (2) for hardware products with embedded software for which VSOE does not exist are based upon ESP. The Company does not believe TPE exists for any of these products and services because they are differentiated from competing products and services in terms of functionality and performance and there are no competing products or services that are largely interchangeable. Management establishes ESP for hardware products with embedded software using a cost plus margin approach with consideration for market conditions, such as the impact of competition and geographic considerations, and entity-specific factors, such as the cost of the product and the Company s profit objectives. Management believes that ESP is reflective of reasonable pricing of that deliverable as if priced on a stand-alone basis. When a sales transaction includes deliverables that are divided between ASC Topic 605 and ASC Subtopic 985-605, the Company allocates the selling price using the relative selling price method whereas value is allocated using an ESP for software developed using a percent of list price approach. The other deliverables are valued using ESP or VSOE as previously discussed.

While the pricing model, currently in use, captures all critical variables, unforeseen changes due to external market forces may result in a revision of the inputs. These modifications may result in the consideration allocation differing from the one presently in use. Absent a significant change in the pricing inputs or the way in which the industry structures its deals, future changes in the pricing model are not expected to materially affect our allocation of arrangement consideration.

Management has established VSOE for hosting services. Billings for hosting are spread ratably over the term of the hosting agreement, with the typical hosting agreement having a term of 12 months, with renewal on an annual basis. The Company sells most hosting contracts without the inclusion of products, and occasionally some hosting contracts in conjunction with the sale of product. When the hosting arrangement is sold in conjunction with product, the product revenue is recognized immediately while the remaining hosting revenue is spread ratably over the term of the hosting agreement. The selling price is allocated between these elements using the relative selling price method. The Company uses the estimated selling price method for development of the selling price for hardware products with embedded software.

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Reserves

We record reserves for stock rotations, price adjustments, rebates, and sales incentives to reduce revenue and accounts receivable for these and other credits we may grant to customers. Such reserves are recorded at the time of sale and are calculated based on historical information (such as rates of product stock rotations) and the specific terms of sales programs, taking into account any other known information about likely customer behavior. If actual customer behavior differs from our expectations, additional reserves may be required. Also, if we determine that we can no longer accurately estimate amounts for stock rotations and sales incentives, we would not be able to recognize revenue until the customers exercise their rights, or such rights lapse, whichever is later.

Credit Evaluation and Allowance for Doubtful Accounts

We assess the realization of our receivables by performing ongoing credit evaluations of our customers financial condition. Through these evaluations, we may become aware of a situation where a customer may not be able to meet its financial obligations due to deterioration of its financial viability, credit ratings or bankruptcy. Our reserve requirements are based on the best facts available to us and are reevaluated and adjusted as additional information is received. Our reserves are also based on amounts determined by using percentages applied to certain aged receivable categories. These percentages are determined by a variety of factors including, but not limited to, current economic trends, historical payment and bad debt write-off experience. Allowance for doubtful accounts for accounts receivable was $90,000 at September 30, 2011 and $105,000 at September 30, 2010.

Impairment of long-lived assets

We assess the impairment of goodwill 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.

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 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 FASB ASC-360-10. Long-lived assets and intangible assets other than goodwill are evaluated for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on expected undiscounted cash flows attributable to that asset.

Valuation allowance for net deferred tax assets

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

Accounting for stock-based compensation

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

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Recent Accounting Pronouncements

The Company adopted in October 2010, the Accounting Standards Update 2009-13, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements* (ASU 2009-13) and ASU 2009-14, *Software (Topic 985) Certain Revenue Arrangements That Include Software Elements* (ASU 2009-14). ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: (i) vendor-specific objective evidence, or VSOE , or (ii) third-party evidence, or TPE , before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity s estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product s essential functionality. These new updates are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Entities must adopt the amendments resulting from both of these ASUs in the same period using the same transition method, where applicable. The adoption of these ASUs did not have a material impact on the Company s consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (ASU 2010-20). The standard amends ASC Topic 310, *Receivables* to enhance disclosures about the credit quality of financing receivables and the allowance for credit losses by requiring an entity to provide a greater level of disaggregated information and to disclose credit quality indicators, past due information, and modifications of its financing receivables. ASU 2010-20 is effective for interim or annual fiscal years beginning after December 15, 2010. The Company s adoption of ASU 2010-20 did not have a material impact on its consolidated financial statements.

In December 2010 the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-28, Intangibles Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts . ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts by requiring an entity to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. This update will be effective for fiscal years beginning after December 15, 2010. The adoption of this guidance is not expected to have an impact on the Company s consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04 Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and IFRSs , (ASU 2011-04), which amends ASC 820. This update clarifies the existing guidance and amends the wording used to describe many of the requirements in US GAAP for measuring fair value and for disclosing information about fair value measurements. This update is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, with prospective application required. The adoption of this guidance is not expected to have an impact on the Company s consolidated financial statements.

In September 2011, the FASB issued ASU 2011-08, Intangible Goodwill and Other (Topic 350) Testing Goodwill for Impairment. The amendments in this ASU permit an entity to first assess qualitative factors related to goodwill to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after

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December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity s financial statements for the most recent annual or interim period have not yet been issued. The adoption of this guidance is not expected to have an impact on the Company s consolidated financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the Company s financial statements upon adoption.

RESULTS OF OPERATIONS

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

Revenue in fiscal 2011 totaled $25.2 million, compared to $20.5 million in fiscal 2010, an increase of 23%. Revenue consisted of the following:

Product revenue from the sale of Mediasite recorder units and server software increased from $10.5 million in fiscal 2010 to $12.8 million in fiscal 2011. Product revenue growth includes an increase in recorders sold to domestic higher education customers including an increase in discounted upgrade recorders sold to customers whose product had reached end of hardware warranty eligibility.

	2011	2010
Units sold	1,250	1,023
Rack to mobile ratio	2.3 to 1	1.9 to 1
Average sales price, excluding support (000 s)	$ 9.6	$ 10.1
Refresh Units	327	158

Services revenue represents the portion of fees charged for Mediasite customer assurance service contracts amortized over the length of the contract, typically 12 months, as well as training, installation, event and content hosting services. Services revenue increased from $9.8 million in fiscal 2010 to $12.2 million in fiscal 2011 due primarily to an increase in hosting and event services as well as an increase in customer support contracts on Mediasite recorder units. At September 30, 2011 $6.0 million of revenue was deferred, of which we expect to recognize approximately $2.4 million in the quarter ending December 31, 2011.

Other revenue relates to freight charges billed separately to our customers.

Gross Margin

Total gross margin in fiscal 2011 was $17.9 million or 71% compared to $15.4 million or 75% in fiscal 2010. Gross margin was affected by an increase in direct and outsourced event labor costs with lower markups for services which the Company does not provide, such as closed captioning. Gross margin was also impacted by a greater volume of discounted upgrade units for customers whose product had reached end of hardware warranty eligibility, an increase in the rack to mobile ratio and by an increase in high definition material cost. These effects were partially offset by a lesser number of higher quantity transactions with corresponding discount pricing in fiscal 2011 than in fiscal 2010. The significant components of cost of revenue include:

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Material and freight costs for the Mediasite recorders. Costs for fiscal 2011 Mediasite recorder hardware and other costs totaled $4.8 million compared to $3.4 million in fiscal 2010. Freight costs were $369 thousand and labor and allocated costs were $813 thousand in fiscal 2011 compared to $226 thousand and $712 thousand in fiscal 2010.

Services costs. Staff wages and other costs allocated to cost of service revenues were $1.4 million in fiscal 2011 and $720 thousand in fiscal 2010, resulting in gross margin on services of 89% in fiscal 2011 and 93% in fiscal 2010. Certain customers contracted with us to provide a suite of professional services, including closed captioning and other services for which we subcontract and charge our customers at significantly lower profit margins. Such sub-contracted services increased by approximately $477 thousand during fiscal 2011 over the prior year.

The Company expects the gross margin percentage to remain constant or higher in fiscal 2012 as total revenue increases and as the Company benefits from manufacturing efficiencies in fiscal 2012.

Operating Expenses

Selling and Marketing Expenses

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

Selling and marketing expense increased $1.25 million, or 13% from $9.5 million in fiscal 2010 to $10.75 million in fiscal 2011. Significant differences include:

Salaries, incentive compensation, and benefits increased $769 thousand over the prior year due to slightly higher staff levels in fiscal 2011 and the increase in sales and corresponding commission compensation compared to fiscal 2010.

Costs also increased by $469 thousand as a result of higher stock compensation expense, bonus and depreciation expense.

At September 30, 2011 we had 64 employees, excluding interns, in Selling and Marketing, an increase from 61 employees at September 30, 2010. We expect our headcount to increase slightly in fiscal 2012 to support future growth.

General and Administrative Expenses

General and administrative (G&A) expenses consist of personnel and related costs associated with the facilities, finance, legal, human resource and information technology departments, as well as other expenses not fully allocated to functional areas.

G&A expenses increased $269 thousand, or 11%, from $2.5 million in fiscal 2010 to $2.8 million in fiscal 2011. Major components of the change include:

An increase in compensation and benefits of $156 thousand, primarily related to a temporary increase in headcount during the second half of the year

Computer supplies increase of $64 thousand, primarily related to employee network support and upgrades

At September 30, 2011 and September 30, 2010 we had 6 full-time employees in G&A. We do not anticipate growth in G&A headcount in fiscal 2012.

Product Development Expenses

Product development (R&D) 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.

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R&D expenses increased $449 thousand, or 14%, from $3.1 million in fiscal 2010 to $3.5 million in fiscal 2011. Some significant differences include:

- Professional services increase of $140 thousand, primarily related to payments made pursuant to a consulting agreement with our former chief technology officer during the second half of fiscal 2011

- Costs also increased by $304 thousand as a result of higher stock compensation expense, bonus and depreciation expense.

At September 30, 2011 we had 24 employees, excluding interns, in Product Development compared to 23 employees at September 30, 2010. We anticipate growth in R&D headcount in fiscal 2012. No fiscal 2011 or 2010 software development efforts qualified for capitalization.

Severance Costs

On September 30, 2011, Rimas Buinevicius resigned his position as Chief Strategy Officer, Executive Chairman of the Board, and Director. The Company has agreed to pay Mr. Buinevicius, in equal bi-weekly installments over a one-year period, an amount equal to one and five hundredths (1.05) multiplied by the highest cash compensation paid to Mr. Buinevicius in any of the last three fiscal years immediately prior to his termination. Mr. Buinevicius unvested stock options also immediately vested on September 30, 2011 upon termination. The consulting agreement with Monty Schmidt, former Chief Technology Officer and Director, was also terminated in September 2011. The remaining six months of Mr. Schmidt s consulting agreement along with Mr. Buinevicius one year severance agreement and immediately vested stock options total $528 thousand of expense have been fully recognized in fiscal 2011. These severance amounts will be paid in full throughout fiscal 2012.

Other Expense, Net

Other income included primarily interest income from investments in certificates of deposit and overnight investment vehicles. Lower interest rates led to a decrease in interest income from $20 thousand in fiscal 2010 to $6 thousand in fiscal 2011. Other expense primarily consists of interest costs related to outstanding debt and amortization of a debt discount. An increased level of debt in the second half of fiscal 2010 associated with a note payable to Partners for Growth was the primary driver of increased interest expense from $190 thousand in fiscal 2010 to $316 thousand in fiscal 2011. Interest in fiscal 2011 includes $142 thousand of non-cash interest associated with the amortization of debt discount relating to the issuance of warrants. The Company paid the balance of the note payable to Partners for Growth in October 2011.

Provisions Related to Income Taxes

The Company records a non-cash deferred tax liability related to goodwill acquired in 2001. The related income tax expense was $240 thousand for both fiscal 2011 and fiscal 2010. The Company netted an income tax credit of $29 thousand against this amount for fiscal 2011 and $15 thousand for fiscal 2010.

LIQUIDITY AND CAPITAL RESOURCES

We fund our operations primarily with cash generated from operations and debt. On September 30, 2011 and 2010, we had cash and cash equivalents of $5.5 million and $3.4 million, respectively.

Cash provided by operating activities totaled $1.4 million in fiscal 2011 and $593 thousand in fiscal 2010, an improvement of $821 thousand. Cash provided in fiscal 2011 was impacted by working capital changes including the negative effects of a $746 thousand increase in accounts receivable and an increase in prepaid expenses and other assets of $307 thousand. These were offset by the positive effects of increases in accounts payable, accrued liabilities and other long-term liabilities of $999 thousand. During 2010, working capital adjustments included the positive effects of an increase in unearned revenue and accounts payable, accrued liabilities and other long-term liabilities of $801 thousand and $122 thousand, respectively. These were offset by the negative effects of an increase in accounts receivable of $1.3 million.

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Cash used in investing activities totaled $739 thousand in fiscal 2011 compared to cash used in investing activities of $464 thousand in fiscal 2010. Investing activities for each of these two years were due to purchases of property and equipment.

Cash provided by financing activities in fiscal 2011 totaled $1.5 million compared to $631 thousand in fiscal 2010. Cash provided in fiscal 2011 was due primarily to proceeds from exercise of common stock options of $1.7 million and $800 thousand of proceeds from notes payable. This was partially offset by $985 thousand of cash used for payments on notes payable. Cash provided in fiscal 2010 was primarily due to a new note payable for $1.25 million partially offset by $613 thousand of cash used for payments on notes payable and the line of credit.

The Company believes its cash position is adequate to accomplish its business plan through at least the next twelve months. We will likely evaluate operating or capital lease opportunities to finance equipment purchases in the future or utilization of the Company s revolving line of credit to support working capital needs. We may also seek additional equity financing, or issue additional shares previously registered in our available shelf registration, although we currently have no plans to do so.

On March 5, 2010, the Company and its wholly-owned subsidiary executed the $1,250,000 Loan and Security Agreement (the Term Loan) with Partners for Growth II. L.P. (PFG). The Term Loan bears interest at 11.75% per annum with principal due in 36 equal monthly payments of $34,722 beginning April 1, 2011 and continuing through March 1, 2014. Coincident with closing of the Term Loan the Company repaid the outstanding balance of its revolving line of credit with Silicon Valley Bank (Silicon Valley Bank). In October 2011, the Company paid off the remaining balance of the Term Loan.

On June 27, 2011, the Companies executed the Second Amended and Restated Loan and Security Agreement with Silicon Valley Bank (the Second Amended Agreement). Under the Second Amended Agreement, the revolving line of credit will continue to have a maximum principal amount of $3,000,000. Interest will accrue on the revolving line of credit at the per annum rate of one percent (1.0%) above the Prime Rate (as defined), provided that Sonic Foundry maintains an Adjusted Quick Ratio (as defined) of greater than 2.0 to 1.0, or one-and-one half percent (1.5%) above the Prime Rate, if Sonic Foundry does not maintain an Adjusted Quick Ratio of greater than 2.0 to 1.0. The Second Amended Agreement does not provide for a minimum interest rate on the revolving loan. The Second Amended Agreement also provides for an increase in the advance rate on domestic receivables from 75% to 80%, and extends the facility maturity date to October 1, 2013. Under the Second Amended Agreement, the existing term loan will continue to accrue interest at a per annum rate equal to the greater of (i) one percentage point (1.0%) above Silicon Valley Bank s prime rate; or (ii) eight and three quarters percent (8.75%). In addition, a new term loan can be issued in multiple draws provided that the total term loan from Silicon Valley Bank shall not exceed $2,000,000 and provided further that total term debt shall not exceed $2,400,000. Under the Second Amended Agreement, any new draws on the term loan will accrue interest at a per annum rate equal to the Prime Rate plus three and three quarters percent (3.75%). The Second Amended Agreement does not provide for a minimum interest rate on the new term loan. Each draw on the new term loan will be amortized over a 36-month period. All draws on the term loan must be made within ten (10) months of June 27, 2011. The Second Amended Agreement also requires Sonic Foundry to continue to comply with certain financial covenants, including covenants to maintain an Adjusted Quick Ratio (as defined) of at least 1.75 to 1.00 and Debt Service Coverage Ratio of at least 1.25 to 1.00, the latter of which will be waived if certain funds are reserved. The Company maintains the revolving line of credit with Silicon Valley and has $1.9 million available for borrowing at September 30, 2011.

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Sonic Foundry, Inc.

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For the Year Ended September 30, 2011

Contractual Obligations

The following summarizes our contractual obligations at September 30, 2011 and the effect those obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

	Total	Less than 1 Year	Years 2-3	Years 4-5	Over 5 years
Contractual Obligations:					
Product purchase commitments	$ 1,314	$ 1,314	$	$	$
Operating lease obligations	4,144	553	1,145	1,193	1,253
Capital lease obligations (a)	290	103	187		
Notes payable (a)	1,763	997	766		

(a) Includes fixed and determinable interest payments

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
Derivative Financial Instruments

We are not party to any derivative financial instruments or other financial instruments for which the fair value disclosure would be required under FASB ASC-815-10. Our 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

Our cash equivalents are subject to interest rate fluctuations, however, we believe this risk is not significant due to the short-term nature of these investments.

At September 30, 2011, $0.6 million of debt outstanding is at a fixed rate and $1.0 million of debt outstanding is variable rate. We do not expect that an increase in the level of interest rates would have a material impact on our Consolidated Financial Statements. We monitor our positions with, and the credit quality of, the financial institutions that are party to any of our financial transactions.

Foreign Currency Exchange Rate Risk

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

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For the Year Ended September 30, 2011

ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Sonic Foundry, Inc.

We have audited the accompanying consolidated balance sheets of Sonic Foundry, Inc. and subsidiary (a Maryland Corporation) as of September 30, 2011 and 2010, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the years then ended. Our audits of the basic consolidated financial statements included the financial statement schedule listed in the index appearing under Item 15(a)(2). These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Sonic Foundry, Inc. and subsidiary as of September 30, 2011 and 2010, and the results of their operations and their cash flows for each of the years then ended, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ GRANT THORNTON LLP

Milwaukee, Wisconsin

November 22, 2011

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Sonic Foundry, Inc.

Consolidated Balance Sheets

(in thousands except for share and per share data)

	September 30, 2011	September 30, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 5,515	$ 3,358
Accounts receivable, net of allowances of $90 and $105	5,799	5,038
Inventories	536	541
Prepaid expenses and other current assets	740	433
Total current assets	12,590	9,370
Property and equipment:		
Leasehold improvements	980	980
Computer equipment	3,586	2,597
Furniture and fixtures	461	461
Total property and equipment	5,027	4,038
Less accumulated depreciation and amortization	3,391	2,801
Net property and equipment	1,636	1,237
Other assets:		
Goodwill	7,576	7,576
Other intangibles, net of amortization of $137 and $71	38	84
Total assets	$ 21,840	$ 18,267
Liabilities and stockholders equity		
Current liabilities:		
Revolving line of credit	$	$
Accounts payable	1,373	1,138
Accrued liabilities	1,073	752
Accrued severance	528	
Unearned revenue	5,547	5,486
Current portion of capital lease obligations	89	
Current portion of notes payable	897	552
Total current liabilities	9,507	7,928
Long-term portion of unearned revenue	471	587
Long-term portion of capital lease obligation	177	
Long-term portion of notes payable	694	1,040
Other liabilities		85
Deferred tax liability	1,730	1,490
Total liabilities	12,579	11,130
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $.01 par value, authorized 500,000 shares; none issued		

5% preferred stock, Series B, voting, cumulative, convertible, $.01 par value (liquidation preference at par), authorized 1,000,000 shares, none issued		
Common stock, $.01 par value, authorized 10,000,000 shares; 3,845,531 and 3,650,823 shares issued and 3,832,815 and 3,638,107 shares outstanding	38	37
Additional paid-in capital	188,339	185,973
Accumulated deficit	(178,921)	(178,678)
Receivable for common stock issued	(26)	(26)
Treasury stock, at cost, 12,716 shares	(169)	(169)
Total stockholders equity	9,261	7,137
Total liabilities and stockholders equity	$ 21,840	$ 18,267

See accompanying notes

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Sonic Foundry, Inc.

Consolidated Statements of Operations

(in thousands except for share and per share data)

	Years Ended September 30, 2011	2010
Revenue:		
Product	$ 12,784	$ 10,477
Services	12,187	9,849
Other	251	150
Total revenue	25,222	20,476
Cost of revenue:		
Product	5,957	4,345
Services	1,354	720
Total cost of revenue	7,311	5,065
Gross margin	17,911	15,411
Operating expenses:		
Selling and marketing	10,755	9,506
General and administrative	2,811	2,542
Severance costs	528	
Product development	3,539	3,090
Total operating expenses	17,633	15,138
Income from operations	278	273
Interest expense	(316)	(190)
Other income, net	6	20
Total other expense, net	(310)	(170)
Income (loss) before income taxes	(32)	103
Provision for income taxes	(211)	(225)
Net loss	$ (243)	$ (122)
Loss per common share:		
Basic net loss per common share	$ (0.06)	$ (0.03)
Diluted net loss per common share	$ (0.06)	$ (0.03)
Weighted average common shares Basic	3,748,840	3,617,423
Diluted	3,748,840	3,617,423

See accompanying notes

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Sonic Foundry, Inc.

Consolidated Statements of Stockholders Equity

For the Year Ended September 30, 2011 and 2010

(in thousands)

	Common stock	Additional paid-in capital	Accumulated Deficit	Receivable for common stock issued	Treasury stock	Total
Balance, September 30, 2009	$ 362	$ 184,990	$ (178,556)	$ (26)	$ (169)	$ 6,601
One for ten reverse stock split	(325)	325				
Stock compensation and other		295				295
Issuance of common stock warrants and common stock		325				325
Exercise of common stock options		38				38
Net loss			(122)			(122)
Balance, September 30, 2010	37	185,973	(178,678)	(26)	(169)	7,137
Stock compensation and other		664				664
Issuance of common stock		32				32
Exercise of common stock warrants and options	1	1,670				1,671
Net loss			(243)			(243)
Balance, September 30, 2011	$ 38	$ 188,339	$ (178,921)	$ (26)	$ (169)	$ 9,261

See accompanying notes

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Sonic Foundry, Inc.

Consolidated Statements of Cash Flows

(in thousands)

	Years Ended September 30, 2011	2010
Operating activities		
Net loss	$ (243)	$ (122)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Amortization of other intangibles	208	73
Depreciation and amortization of property and equipment	704	543
Provision for doubtful accounts	(15)	
Deferred taxes	240	240
Stock-based compensation expense related to stock options	707	295
Changes in operating assets and liabilities:		
Accounts receivable	(746)	(1,297)
Inventories	(78)	(101)
Prepaid expenses and other assets	(307)	39
Accounts payable, accrued liabilities and other long-term liabilities	999	122
Unearned revenue	(55)	801
Net cash provided by operating activities	1,414	593
Investing activities		
Purchases of property and equipment	(739)	(464)
Net cash used in investing activities	(739)	(464)
Financing activities		
Net proceeds from (payments on) revolving line of credit		(300)
Proceeds from notes payable	800	1,250
Payments on notes payable	(985)	(313)
Payments of loan fees	(21)	(90)
Proceeds from issuance of common stock	32	70
Proceeds from exercise of common stock warrants and options	1,671	38
Payments on capital leases	(15)	(24)
Net cash provided by financing activities	1,482	631
Net increase in cash and cash equivalents	2,157	760
Cash and cash equivalents at beginning of period	3,358	2,598
Cash and cash equivalents at end of period	$ 5,515	$ 3,358
Supplemental cash flow information:		
Interest paid	174	153
Non-cash transactions:		
Property and equipment financed by accounts payable, accrued liabilities or capital lease	330	63

See accompanying notes

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Sonic Foundry, Inc.

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1. Basis of Presentation and Significant Accounting Policies

Business

Sonic Foundry, Inc. (the Company) is in the business of providing enterprise solutions and services for the web communications market.

Reverse Stock Split

Effective November 16, 2009, the Company implemented a one-for-ten reverse stock split of its stock. All shares and per share data in this report have been adjusted to reflect this reverse stock split.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Sonic Foundry Media Systems, Inc. All significant intercompany transactions and balances have been eliminated. In 2011 and 2010, net loss equaled comprehensive loss as there were no items of comprehensive income.

Use of Estimates

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

Revenue Recognition

General

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

Products

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

Services

The Company sells support and content hosting contracts to our customers, typically one year in length, and records 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 distribution partners, software upgrades on a when and if available basis, advance hardware replacement and an extension of the standard hardware warranty from 90 days to one year. The manufacturers we contract with to build the units provide a limited one-year warranty on the hardware. We also sell installation, training, event webcasting, and customer content hosting services. Revenue for

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Sonic Foundry, Inc.

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those services is recognized when performed in the case of installation, training and event webcasting services and is recognized ratably over the contract period when these additional elements are sold with hosting. Service amounts invoiced to customers in excess of revenue recognized are recorded as deferred revenue until the revenue recognition criteria are met.

Revenue Arrangements that Include Multiple Elements

The Company has historically applied the software revenue recognition rules as prescribed by Accounting Standards Codification (ASC) Subtopic 985-605. In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) Number 2009-14, Certain Revenue Arrangements That Include Software Elements, which amended ASC Subtopic 985-605. This ASU removes tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of the software revenue recognition rules. In the case of the Company s hardware products with embedded software, the Company has determined that the hardware and software components function together to deliver the product s essential functionality, and therefore, the revenue from the sale of these products no longer falls within the scope of the software revenue recognition rules. Revenue from the sale of software-only products remains within the scope of the software revenue recognition rules. Installation, training, and post customer support no longer fall within the scope of the software revenue recognition rules, except when they are sold with and relate to a software-only product. Revenue recognition for products that no longer fall under the scope of the software revenue recognition rules is similar to that for other tangible products. ASU Number 2009-13, Multiple-Deliverable Revenue Arrangements, which amended ASC Topic 605 and was also issued in October 2009, is applicable for multiple-deliverable revenue arrangements. ASU 2009-13 allows companies to allocate revenue in a multiple-deliverable arrangement in a manner that better reflects the transaction s economics. ASU 2009-13 and 2009-14 were adopted and are effective for revenue arrangements entered into or materially modified in the Company s fiscal year 2011.

Under the software revenue recognition rules, the fee from a multiple-deliverable arrangement is allocated to each of the undelivered elements based upon vendor-specific objective evidence (VSOE), which is limited to the price charged when the same deliverable is sold separately, with the residual value from the arrangement allocated to the delivered element. The portion of the fee that is allocated to each deliverable is then recognized as revenue when the criteria for revenue recognition are met with respect to that deliverable. If VSOE does not exist for all of the undelivered elements, then all revenue from the arrangement is typically deferred until all elements have been delivered to the customer. All revenue arrangements, with the exception of hosting contracts, entered into prior to October 1, 2010 and the sale of all software-only products and associated services have been accounted for under this guidance during the year ended September 30, 2011.

Under the revenue recognition rules for tangible products as amended by ASU 2009-13, the fee from a multiple-deliverable arrangement is allocated to each of the deliverables based upon their relative selling prices as determined by a selling-price hierarchy. A deliverable in an arrangement qualifies as a separate unit of accounting if the delivered item has value to the customer on a stand-alone basis. A delivered item that does not qualify as a separate unit of accounting is combined with the other undelivered items in the arrangement and revenue is recognized for those combined deliverables as a single unit of accounting. The selling price used for each deliverable is based upon VSOE if available, third-party evidence (TPE) if VSOE is not available, and best estimate of selling price (ESP) if neither VSOE nor TPE are available. TPE is the price of the Company s or any competitor s largely interchangeable products or services in stand-alone sales to similarly situated customers. ESP is the price at which the Company would sell the deliverable if it were sold regularly on a stand-alone basis, considering market conditions and entity-specific factors. All revenue arrangements negotiated after September 30, 2010, excluding the sale of all software-only products and associated services, have been accounted for under this guidance during the year ended September 30, 2011.

The selling prices used in the relative selling price allocation method are as follows: (1) for the Company s products and certain services are based upon VSOE, (2) for hardware products with embedded software for which VSOE does not exist are based upon ESP. The Company does not believe TPE exists for any of these products and services because they are differentiated from competing products and services in terms of functionality and performance and

Sonic Foundry, Inc.

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there are no competing products or services that are largely interchangeable. Management establishes ESP for hardware products with embedded software using a cost plus margin approach with consideration for market conditions, such as the impact of competition and geographic considerations, and entity-specific factors, such as the cost of the product and the Company s profit objectives. Management believes that ESP is reflective of reasonable pricing of that deliverable as if priced on a stand-alone basis. When a sales transaction includes deliverables that are divided between ASC Topic 605 and ASC Subtopic 985-605, the Company allocates the selling price using the relative selling price method whereas value is allocated using an ESP for software developed using a percent of list price approach. The other deliverables are valued using ESP or VSOE as previously discussed.

While the pricing model, currently in use, captures all critical variables, unforeseen changes due to external market forces may result in a revision of the inputs. These modifications may result in the consideration allocation differing from the one presently in use. Absent a significant change in the pricing inputs or the way in which the industry structures its deals, future changes in the pricing model are not expected to materially affect our allocation of arrangement consideration.

Management has established VSOE for hosting services. Billings for hosting are spread ratably over the term of the hosting agreement, with the typical hosting agreement having a term of 12 months, with renewal on an annual basis. The Company sells most hosting contracts without the inclusion of products, and occasionally some hosting contracts in conjunction with the sale of product. When the hosting arrangement is sold in conjunction with product, the product revenue is recognized immediately while the remaining hosting revenue is spread ratably over the term of the hosting agreement. The selling price is allocated between these elements using the relative selling price method. The Company uses the estimated selling price method for development of the selling price for hardware products with embedded software.

Reserves

The Company records reserves for stock rotations, price adjustments, rebates, and sales incentives to reduce revenue and accounts receivable for these and other credits granted to customers. Such reserves are recorded at the time of sale and are calculated based on historical information (such as rates of product stock rotations) and the specific terms of sales programs, taking into account any other known information about likely customer behavior. If actual customer behavior differs from our expectations, additional reserves may be required. Also, if the Company determines that it can no longer accurately estimate amounts for stock rotations and sales incentives, the Company would not be able to recognize revenue until resellers sell the inventory to the final end user.

Shipping and Handling

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

Concentration of Credit Risk and Other Risks and Uncertainties

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

We assess the realization of our receivables by performing ongoing credit evaluations of our customers financial condition. Through these evaluations, we may become aware of a situation where a customer may not be able to meet its financial obligations due to deterioration of its financial viability, credit ratings or bankruptcy. Our reserve requirements are based on the best facts available to us and are reevaluated and adjusted as additional information is received. Our reserves are also based on amounts determined by using percentages applied to certain aged receivable categories. These percentages are determined by a variety of factors including, but not limited to, current economic trends, historical payment and bad debt write-off experience. Allowance for doubtful accounts for accounts receivable was $90,000 at September 30, 2011 and $105,000 at September 30, 2010.

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We had billings for Mediasite product and support services as a percentage of total billings to one distributor of approximately 24% in 2011 and 32% in 2010 and to a second distributor of approximately 26% in 2011 and 22% in 2010. At September 30, 2011 and 2010, these two distributors represented 68% and 57%, respectively of total accounts receivable.

Currently all of our product inventory purchases are from two suppliers. Although we believe there are multiple sources of supply from other contract manufacturers as well as multiple suppliers of component parts required by the contract manufacturers, a disruption of supply of component parts or completed products, even if short term, would have a negative impact on our revenues. At September 30, 2011 and 2010, these two suppliers represented 21% and 55%, respectively of total accounts payable.

Cash and Cash Equivalents

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

Trade Accounts Receivable

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

Inventory Valuation

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

Inventory consists of the following (in thousands):

	September 30, 2011	September 30, 2010
Raw materials and supplies	$ 10	$ 10
Finished goods	526	531
	$ 536	$ 541

Software Development Costs

Internal software development costs are capitalized after technological feasibility is established. The capitalized cost is then amortized on a straight-line basis over the estimated product life, or on the ratio of current revenue to total projected product revenue, whichever is greater. To date, the period between achieving technological feasibility, which the Company has defined as the establishment of a working model, typically occurs when the beta testing commences, and the general availability of such software has been short and software development costs qualifying for capitalization have been insignificant. Accordingly, the Company has not capitalized any internal software development costs.

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For the Year Ended September 30, 2011

Property and Equipment

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

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

Impairment of Long-Lived Assets

We assess the impairment of goodwill 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.

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 indicators of impairment, we would then measure impairment based on a comparison of the implied fair value of goodwill with the carrying amount of goodwill. To the extent the carrying amount of goodwill is greater than the implied fair value of goodwill, we would record an impairment charge for the difference. The Company has recognized no such losses as of September 30, 2011 and 2010.

Long-lived assets and intangible assets other than goodwill are evaluated for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on expected undiscounted cash flows attributable to that asset. For the years ended September 30, 2011 and 2010, no events or changes in circumstances occurred that required this analysis.

Advertising Expense

Advertising costs included in selling and marketing, are expensed when the advertising first takes place. Advertising expense was $169 and $156 thousand for years ended September 30, 2011 and 2010, respectively.

Research and Development Costs

Research and development costs are expensed in the period incurred.

Income Taxes

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

The Company also accounts for the uncertainty in income taxes related to the recognition and measurement of a tax position and measurement of a tax position taken or expected to be taken in an income tax return. The Company follows the applicable accounting guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure related to the uncertainty in income tax positions.

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

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Stock-Based Compensation

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

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

	Years Ending September 30, 2011	2010
Expected life	4.4 4.8 years	4.4 5.5 years
Risk-free interest rate	0.4% 1.4%	0.8% 1.4%
Expected volatility	68.2% 83.0%	83.2% 87.2%
Expected forfeiture rate	12.80% 17.70%	15.41% 18.38%
Expected exercise factor	1.15 1.32	1.19 2.23
Expected dividend yield	0%	0%

Per Share Computation

Basic and diluted net loss per share information for all periods is presented under the requirements of FASB ASC-260-10. Basic earnings per share has been computed using the weighted-average number of shares of common stock outstanding during the period, less shares that may be repurchased, and excludes any dilutive effects of options and warrants. If the Company had reported net income during the periods presented below, diluted net income per share would have been computed using common equivalent shares related to outstanding options and warrants to purchase common stock. The numerator for the calculation of basic and diluted earnings per share is net 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, 2011	2010
Denominator for basic earnings per share		
- weighted average common shares	3,748,840	3,617,423
Effect of dilutive options and warrants (treasury method)		
Denominator for diluted earnings per share		
- adjusted weighted average common shares	3,748,840	3,617,423
Options and warrants outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive	787,347	855,792

Recent Accounting Pronouncements

The Company adopted in October 2010, the Accounting Standards Update 2009-13, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements* (ASU 2009-13) and ASU 2009-14, *Software (Topic 985) Certain Revenue Arrangements That Include Software Elements* (ASU 2009-14). ASU 2009-13 modifies the

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requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: (i) vendor-specific objective evidence, or VSOE , or (ii) third-party evidence, or TPE , before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity s estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product s essential functionality. These new updates are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Entities must adopt the amendments resulting from both of these ASUs in the same period using the same transition method, where applicable. The adoption of these ASUs did not have a material impact on the Company s consolidated financial statements.

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (ASU 2010-20). The standard amends ASC Topic 310, *Receivables* to enhance disclosures about the credit quality of financing receivables and the allowance for credit losses by requiring an entity to provide a greater level of disaggregated information and to disclose credit quality indicators, past due information, and modifications of its financing receivables. ASU 2010-20 is effective for interim or annual fiscal years beginning after December 15, 2010. The Company s adoption of ASU 2010-20 did not have a material impact on its consolidated financial statements.

In December 2010 the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-28, Intangibles Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts . ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts by requiring an entity to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. This update will be effective for fiscal years beginning after December 15, 2010. The adoption of this guidance is not expected to have an impact on the Company s consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04 Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and IFRSs , (ASU 2011-04), which amends ASC 820. This update clarifies the existing guidance and amends the wording used to describe many of the requirements in US GAAP for measuring fair value and for disclosing information about fair value measurements. This update is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, with prospective application required. The adoption of this guidance is not expected to have an impact on the Company s consolidated financial statements.

In September 2011, the FASB issued ASU 2011-08, Intangible Goodwill and Other (Topic 350) Testing Goodwill for Impairment. The amendments in this ASU permit an entity to first assess qualitative factors related to goodwill to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity s financial statements for the most recent annual or interim period have not yet been issued. The adoption of this guidance is not expected to have an impact on the Company s consolidated financial statements.

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Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the Company s financial statements upon adoption.

2. Commitments

The Company leases certain equipment under capital lease agreements expiring through August 2014. Such leases are included in fixed assets with a cost of $282 thousand and accumulated depreciation of $10 thousand at September 30, 2011. Minimum lease payments, including principal and interest, are summarized in the table below.

Fiscal Year (in thousands)	Capital
2012	$ 103
2013	103
2014	84
Total payments	290
Less interest	(24)
Total	$ 266

The Company leases certain facilities and equipment under operating lease agreements expiring at various times through September 30, 2018. Total rent expense related to continuing operations on all operating leases was approximately $522 thousand and $501 thousand for the years ended September 30, 2011 and 2010, respectively.

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

Fiscal Year (in thousands)	Operating
2012	$ 553
2013	566
2014	579
2015	589
2016	604
Thereafter	1,253
Total	$ 4,144

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. The Company has an obligation to purchase $1.3 million at September 30, 2011, which is not recorded on the Company s Consolidated Balance Sheet.

The Company enters into license agreements that generally provide indemnification against intellectual property claims for its customers as well as indemnification agreements with certain service providers, landlords and other parties in the normal course of business. The Company has not incurred any material costs as a result of such indemnifications and has not accrued any liabilities related to such obligations in the consolidated financial statements.

3. Credit Arrangements

On June 16, 2008, the Company and its wholly-owned subsidiary, Sonic Foundry Media Systems, Inc. (collectively, the Companies) entered into an Amended and Restated Loan and Security Agreement (the Amended Loan Agreement) with Silicon Valley Bank (Silicon Valley Bank) providing for a credit facility in the form of a $3,000,000 secured revolving line of credit and a $1,000,000 term loan. The ability to borrow up to the maximum $3,000,000 amount of the revolving line of credit is determined by applying an applicable percentage to eligible accounts receivable, which, is reduced by, among other things, a reserve. Prior to the First Amendment, discussed below, the reserve was equal to the balance of the term loan when EBITDA, as defined, would have been less than

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$200,000 during the preceding six month period. Prior to the Second Amended Agreement, discussed below, the revolving line of credit accrued interest at a per annum rate equal to the following: (i) during such period that Sonic Foundry maintained an Adjusted Quick Ratio (as defined) of greater than 2.00 to 1.00, the greater of one percentage point (1.0%) above Silicon Valley Bank s prime rate, or seven percent (7.0%); or (ii) during such period that Sonic Foundry maintained an Adjusted Quick Ratio equal to or less than 2.00 to 1.00, the greater of one and one-half percent (1.5%) above Silicon Valley Bank s prime rate, or seven and one-half percent (7.5%). Under the Amended Loan Agreement and the Second Amended Agreement, the outstanding term loan will continue to accrue interest at a per annum rate equal to the greater of (i) one percentage point (1.0%) above Silicon Valley s prime rate; or (ii) eight and three quarters percent (8.75%). Prior to the First Amendment, the maturity of both the term loan and the revolving line of credit was June 1, 2010. At the maturity date all outstanding borrowings and any unpaid interest thereon must be repaid, and all outstanding letters of credit must be cash collateralized. Principal on the term loan is to be repaid in thirty-six (36) monthly installments, and prior to the First Amendment as defined below, was to be repaid in full on May 1, 2010.

On April 14, 2009, the Companies executed the First Amendment to the Amended Loan Agreement with Silicon Valley Bank (the First Amendment). The First Amendment, among other things, a) refinanced the $361,111 outstanding balance of the Term Loan with a new Term Loan 2 in the amount of $1,000,000, due in 36 equal monthly installments of principal and interest; b) continued to require a reserve under the Revolving Line for the balance of the term loan unless, for three (3) consecutive monthly periods, the ratio of EBITDA to Debt Service, in each case for the three (3) month period then ending is greater than or equal to 1.25 to 1.00; c) modified the minimum requirements under the EBITDA covenant, but maintained a provision to override such covenant if the Company maintains a minimum Adjusted Quick Ratio of 1.75 to 1.00; and d) extended the maturity date of the Revolving Line to October 1, 2011 and the Term Loan 2 to April 1, 2012. The First Amendment also required the Company to continue to maintain certain of their depository, operating and securities accounts with Silicon Valley Bank, and to continued to comply with certain other restrictive loan covenants, including covenants limiting the Companies ability to dispose of assets, make acquisitions, be acquired, incur indebtedness, grant liens, make investments, pay dividends, and repurchase stock.

On June 27, 2011, the Companies executed the Second Amended and Restated Loan and Security Agreement with Silicon Valley Bank (the Second Amended Agreement). Under the Second Amended Agreement, the revolving line of credit will continue to have a maximum principal amount of $3,000,000. Interest will accrue on the revolving line of credit at the per annum rate of one percent (1.0%) above the Prime Rate (as defined), provided that Sonic Foundry maintains an Adjusted Quick Ratio (as defined) of greater than 2.0 to 1.0, or one-and-one half percent (1.5%) above the Prime Rate, if Sonic Foundry does not maintain an Adjusted Quick Ratio of greater than 2.0 to 1.0. The Second Amended Agreement does not provide for a minimum interest rate on the revolving loan. The Second Amended Agreement also provides for an increase in the advance rate on domestic receivables from 75% to 80%, and extends the facility maturity date to October 1, 2013. Under the Second Amended Agreement, the existing term loan will continue to accrue interest at a per annum rate equal to the greater of (i) one percentage point (1.0%) above Silicon Valley Bank s prime rate; or (ii) eight and three quarters percent (8.75%). In addition, a new term loan can be issued in multiple draws provided that the total term loan from Silicon Valley Bank shall not exceed $2,000,000 and provided further that total term debt shall not exceed $2,400,000. Under the Second Amended Agreement, any new draws on the term loan will accrue interest at a per annum rate equal to the Prime Rate plus three and three quarters percent (3.75%). The Second Amended Agreement does not provide for a minimum interest rate on the new term loan. Each draw on the new term loan will be amortized over a 36-month period. All draws on the term loan must be made within ten (10) months of June 27, 2011. The Second Amended Agreement also requires Sonic Foundry to continue to comply with certain financial covenants, including covenants to maintain an Adjusted Quick Ratio (as defined) of at least 1.75 to 1.00 and Debt Service Coverage Ratio of at least 1.25 to 1.00, the latter of which will be waived if certain funds are reserved.

At September 30, 2011, a balance of $982 thousand was outstanding on the term loans with Silicon Valley Bank and no balance was outstanding on the revolving line of credit. At September 30, 2011, there was $1.9 million available under this credit facility for advances and $1.2 million was available for advances under the term loan. At September 30, 2011 the Company was in compliance with all covenants in the Second Amended Agreement.

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The Second Amended Agreement contains events of default that include, among others, non-payment of principal or interest, inaccuracy of any representation or warranty, violation of covenants, bankruptcy and insolvency events, material judgments, cross defaults to certain other indebtedness, and material adverse changes. The occurrence of an event of default could result in the acceleration of the Companies obligations under the Second Amended Agreement.

Pursuant to the Second Amended Agreement, the Companies pledged as collateral to Silicon Valley Bank substantially all non-intellectual property business assets. The Companies also entered into an Intellectual Property Security Agreement with respect to intellectual property assets.

Partners for Growth

On March 5, 2010, the Companies executed a $1,250,000 Loan and Security Agreement (the Term Loan) and a $750,000 Revolving Loan and Security Agreement (the Revolving Loan) with Partners for Growth II, L.P. (PFG), (collectively the Agreements).

The Term Loan bore interest at 11.75% per annum with principal due in 36 equal monthly payments of $34,722 beginning April 1, 2011 and continuing through March 1, 2014. At September 30, 2011, a balance of $642 thousand was outstanding on the Term Loan. In October 2011, the Company paid the remaining balance of the Term Loan.

At September 30, 2011, the Term Loan was collateralized by substantially all the Companies assets, including intellectual property, subject to a first lien held by Silicon Valley Bank. The Term Loan required compliance with an adjusted quick ratio covenant of 1.75:1.00. As of September 30, 2011, the Companies were in compliance with this covenant.

Coincident with execution of the Agreements, the Company entered into a Warrant Purchase Agreement (Purchase Agreement) and a Warrant Agreement (Warrant) with PFG. Pursuant to the terms of the Purchase Agreement, PFG purchased a warrant to purchase up to 76,923 shares of common stock of the Company at an exercise price of $6.25 per share, subject to certain adjustments, for a purchase price of $3,333. A warrant to purchase 48,077 shares of common stock was immediately exercisable. PFG exercised 24,039 shares in November 2010 and the remaining 24,038 shares in January 2011. Both such warrant exercise transactions were completed on a cashless basis resulting in 14,595 and 13,712 shares issued, respectively. The remaining warrant to purchase 28,846 shares of common stock has expired.

The Company valued the warrants issued pursuant to the Purchase Agreement using the Black-Scholes method assuming a 1) life of seven years; 2) volatility factor of 86.9%; 3) risk free interest rate of 1.38%. The resulting value of the warrants, less $3,333 proceeds received from PFG, is treated as a debt discount and netted against the carrying value of the Term Loan on the consolidated balance sheet. The discount is amortized at a constant rate applied to the outstanding balance of the Term Loan with a corresponding increase to non-cash interest expense. At September 30, 2011 the remaining balance of the discount was $32 thousand.

On June 28, 2011, the Companies entered into a Consent and Modification No. 1 to Loan and Security Agreement (Consent and Modification Agreement) with PFG. Under the Consent and Modification Agreement, PFG consented to the Companies incurring additional indebtedness to Silicon Valley Bank, provided that total outstanding term indebtedness owed to PFG and Silicon Valley Bank does not exceed $1,900,000.

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The annual principal payments on the term loans were as follows:

Fiscal Year (in thousands)	
2012	$ 897
2013	492
2014	234
Total	1,623
Debt discount	(32)
Net total	$ 1,591

4. Common Stock Warrants

The Company has issued restricted common stock purchase warrants to various consultants and other third parties. Each warrant represents the right to purchase one share of common stock. All warrants are currently exercisable. The Company did not grant any warrants in fiscal 2011 and granted 48,077 warrants in fiscal 2010. All such warrants are either valued and expensed in full at the date of grant or valued at the date of grant and deferred over the term of the relevant contract for services.

Exercise Prices	Warrants Outstanding at September 30, 2011	Expiration Date
$ 23.50	750	2012
36.70-37.10	1,050	2011 to 2012
	1,800	

5. Stock Options and Employee Stock Purchase Plan

On March 5, 2009, Stockholders approved adoption of the 2009 Stock Incentive Plan (the 2009 Plan). The 2009 Plan, beginning October 1, 2009, replaced two former employee stock option plans that terminated coincident with the effectiveness of the 2009 Plan. The Company also maintains a directors stock option plan under which options may be issued to purchase up to an aggregate of 50,000 shares of common stock. Each non-employee director, who is re-elected or who continues as a member of the board of directors on each annual meeting date and on each subsequent meeting of Stockholders, will be granted options to purchase 2,000 shares of common stock under the directors plan, or at other times or amounts at the discretion of the Board of Directors.

Each option entitles the holder to purchase one share of common stock at the specified option price. The exercise price of each option granted under the plans was set at the fair market value of the Company s common stock at the respective grant date. Options vest at various intervals and expire at the earlier of termination of employment, discontinuance of service on the board of directors, ten years from the grant date or at such times as are set by the Company at the date of grant.

Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period.

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

	Qualified Employee Stock Option Plans	Director Stock Option Plans
Shares available for grant at September 30, 2009	375,400	30,000
Options granted	(52,250)	(10,500)
Options forfeited	4,150	
Shares available for grant at September 30, 2010	327,300	19,500
Options granted	(189,051)	(12,500)
Options forfeited	13,634	
Shares available for grant at September 30, 2011	151,883	7,000

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

	Years Ended September 30,			
	2011		2010	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of year	764,718	$ 10.98	766,615	$ 16.20
Granted	201,551	12.64	62,750	6.63
Exercised	(138,496)	10.08	(14,198)	8.22
Forfeited	(42,226)	11.69	(50,449)	85.41
Outstanding at end of year	785,547	$ 11.52	764,718	$ 10.98
Exercisable at end of year	535,668		555,587	
Weighted average fair value of options granted during the year	$ 5.39		$ 3.64	

The options outstanding at September 30, 2011 have been segregated into four ranges for additional disclosure as follows:

	Options Outstanding			Options Exercisable	
Exercise Prices	Options Outstanding at	Weighted Average	Weighted Average	Options Exercisable	Weighted Average

	September 30, 2011	Remaining Contractual Life	Exercise Price	at September 30, 2011	Exercise Price
$ 4.20 to $9.90	356,094	7.4	$ 6.52	244,667	$ 6.19
10.10 to 14.83	253,119	5.5	12.71	147,193	12.13
15.00 to 19.40	127,251	6.5	15.94	94,725	16.19
20.80 to 46.90	49,083	5.0	32.65	49,083	32.65
	785,547			535,668	

At September 30, 2011, there was $851 thousand of total unrecognized compensation cost related to non-vested stock-based compensation, including $140 thousand of estimated forfeitures. The cost is expected to be recognized over a weighted-average life of 2.2 years.

A summary of the status of the company s non-vested shares at September 30, 2011 and for the year then ended is presented below:

	Shares	Weighted Average Grant Date Fair Value
Non-vested shares at October 1, 2010	209,131	$ 4.28
Granted	201,551	5.39
Vested	(132,876)	4.88
Forfeited	(27,927)	4.42
Non-vested shares at September 30, 2011	249,879	$ 5.05

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Stock-based compensation recorded in the year ended September 30, 2011 of $707 thousand was allocated $482 thousand to selling and marketing expenses, $49 thousand to general and administrative expenses and $176 thousand to product development expenses. Stock-based compensation recorded in the year ended September 30, 2010 of $295 thousand was allocated $199 thousand to selling and marketing expenses, $21 thousand to general and administrative expenses and $75 thousand to product development expenses. Cash received from exercises under all stock option plans and warrants for the years ended September 30, 2011 and 2010 was $1.7 million and $38 thousand, respectively. There were no tax benefits realized for tax deductions from option exercises for the years ended September 30, 2011 and 2010. The Company currently expects to satisfy stock-based awards with registered shares available to be issued.

The Company also has an Employee Stock Purchase Plan (Purchase Plan) under which an aggregate of 100,000 common shares may be issued. The Shareholders approved an amendment to increase the number of shares of common stock subject to the plan from 50,000 to 100,000 at the Company s annual meeting in March 2011. All employees who have completed 90 days of employment with the Company on the first day of each offering period and customarily work twenty hours per week or more are eligible to participate in the Purchase Plan. An employee who, after the grant of an option to purchase, would hold common stock and/or hold outstanding options to purchase stock possessing 5% or more of the total combined voting power or value of the Company will not be eligible to participate. Eligible employees may make contributions through payroll deductions of up to 10% of their compensation. No participant in the Purchase Plan is permitted to purchase common stock under the Purchase Plan if such option would permit his or her rights to purchase stock under the Purchase Plan to accrue at a rate that exceeds $25,000 of the fair market value of such shares, or that exceeds 1,000 shares, for each calendar year. The Company makes a bi-annual offering to eligible employees of options to purchase shares of common stock under the Purchase Plan on the first trading day of January and July. Each offering period is for a period of six months from the date of the offering, and each eligible employee as of the date of offering is entitled to purchase shares of common stock at a purchase price equal to the lower of 85% of the fair market value of common stock on the first or last trading day of the offering period. A total of 50,418 shares are available to be issued under the plan. Due to the timing of the increase of shares pursuant to the plan, the Company did not offer any shares for purchase during the six month period ending June 30, 2011. There were 5,405 and 17,053 shares purchased by employees during fiscal 2011 and 2010, respectively. The Company recorded stock compensation expense under this plan of $16 and $23 thousand during fiscal 2011 and 2010, respectively. Cash received from issuance of stock under this plan was $32 and $70 thousand during fiscal 2011 and 2010, respectively.

6. Income Taxes

The provision for income taxes consists of the following (in thousands):

	Years Ended September 30,	
	2011	**2010**
Current tax benefit	$ (29)	$ (15)
Deferred income tax expense	240	240
Provision for income taxes	$ 211	$ 225

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,	
	2011	**2010**
Income tax expense (benefit) at U.S. statutory rate of 34%	$ (11)	$ 35

Federal income tax refundable research credit	(29)	(15)
State income tax expense (benefit)	(2)	5
Permanent differences, net	158	13

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Adjustment of temporary differences to income tax returns	212	1,560
Change in valuation allowance	(117)	(1,373)
Income tax expense	$ 211	$ 225

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

	September 30, 2011	2010
Deferred tax assets:		
Net operating loss and other carryforwards	$ 34,444	$ 34,663
Common stock warrants	460	398
Allowance for doubtful accounts	35	41
Other	249	203
Total deferred tax assets	35,188	35,305
Valuation allowance	(35,188)	(35,305)
Goodwill amortization	(1,730)	(1,490)
Deferred tax liability for goodwill amortization	$ (1,730)	$ (1,490)

At September 30, 2011, the Company had net operating loss carryforwards of approximately $87 million for U.S. Federal and $51 million for state tax purposes. For Federal tax purposes, the carryforwards expire in varying amounts between 2018 and 2031. For State tax purposes, the carryforwards expire in varying amounts between 2013 and 2030. Utilization of the Company s net operating loss may be subject to substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. Such an annual limitation could result in the expiration of the net operating loss carryforwards before utilization. In addition, the Company has research and development tax credit carryforwards of approximately $500 thousand, which expire in varying amounts between 2017 and 2020.

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

Beginning with an acquisition in fiscal year 2002, the Company has amortized Goodwill for tax purposes over a 15 year life. Goodwill is not amortized for book purposes. Annual impairment tests are performed for book purposes and the balance of goodwill is to be written down if impairment occurs. The impairment tests have not indicated any goodwill impairment.

The difference between the book and tax balance of Goodwill creates a Deferred Tax Liability and an annual tax expense. Because of the long term nature of the goodwill timing difference, tax planning strategies cannot be applied related to the Deferred Tax Liability. The balance of the Deferred Tax Liability at September 30, 2011 was $1.73 million and $1.49 million at September 30, 2010.

In accordance with accounting guidance for uncertainty in income taxes, the Company has concluded that a reserve for income tax contingencies is not necessary. The Company s practice is to recognize interest and/or penalties related to income tax matters in income tax expense. The Company had no accruals for interest and penalties on the Company s consolidated balance sheets at September 30, 2011 and 2010, and has not recognized any interest or penalties in the consolidated statement of operations for the years ended September 30, 2011 or 2010. The Company s tax rate differs from the expected tax rate each reporting period as a result of the aforementioned items.

The Company is subject to taxation in the U.S. and various state jurisdictions. All of the Company s tax years are subject to examination by the U.S. and state tax authorities due to the carryforward of unutilized net operating losses.

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7. Savings Plan

The Company s defined contribution 401(k) savings plan covers substantially all employees meeting certain minimum eligibility requirements. Participating employees can elect to defer a portion of their compensation and contribute it to the plan on a pretax basis. The Company may also match certain amounts and/or provide additional discretionary contributions, as defined. The Company made matching contributions of $229 and $66 thousand during the years ended September 30, 2011 and 2010, respectively. The Company suspended the matching contribution for the 2010 calendar year. The Company made no additional discretionary contributions during 2011 and 2010.

8. Related-Party Transactions

The Company incurred fees of $220 and $244 thousand during the years ended September 30, 2011 and 2010, respectively, to a law firm whose partner is a director and stockholder of the Company. The Company had accrued liabilities for unbilled services to the same law firm of $50 and $54 thousand at September 30, 2011 and 2010, respectively.

The Company recorded Mediasite product and customer support revenue related to $861 and $566 thousand of billings during the years ended September 30, 2011 and 2010 to Mediasite KK, a Japanese reseller in which the Company has an equity interest. Mediasite KK owed the Company $241 and $63 thousand on such billings at September 30, 2011 and 2010, respectively. The Company accounts for its investment in Mediasite KK under the equity method. The recorded value at September 30, 2011 and 2010 is zero.

During the years ended September 30, 2011 and 2010, the Company had a loan outstanding to an executive totaling $26 thousand. The loan is collateralized by Company stock.

9. Goodwill and Other Intangible Assets

Goodwill and intangible assets that have indefinite useful lives are not amortized but, instead, tested at least annually for impairment. The Company assesses the impairment of goodwill 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.

If the Company determines that the fair value of goodwill is less than its carrying value, based upon the annual test or the existence of impairment, the Company 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, an impairment charge for the difference would be recorded. The Company performed its annual goodwill impairment test as of July 1, 2011 and tested goodwill recognized in connection with the acquisition of Mediasite and determined it was not impaired.

The following tables present details of the Company s total intangible assets at September 30, 2011 and 2010:

(in thousands)	Life (years)	Gross	Accumulated Amortization at September 30, 2011	Balance at September 30, 2011
Amortizable:				
Loan origination fees	3	$ 175	$ 137	$ 38

	175	137	38
Non-amortizable goodwill	7,576		7,576
Total	$ 7,751	$ 137	$ 7,614

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Sonic Foundry, Inc.

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For the Year Ended September 30, 2011

(in thousands)	Life (years)	Gross	Accumulated Amortization at September 30, 2010	Balance at September 30, 2010
Amortizable:				
Loan origination fees	3	$ 155	$ 71	$ 84
		155	71	84
Non-amortizable goodwill		7,576		7,576
Total		$ 7,731	$ 71	$ 7,660

10. Segment Information

The Company has determined that it operates in only one segment as it does not disaggregate profit and loss information on a segment basis for internal management reporting purposes to its chief operating decision maker.

The Company s long-lived assets maintained outside the United States are insignificant.

The following summarizes revenue by geographic region (in thousands):

	Years Ended September 30, 2011	2010
United States	$ 19,231	$ 16,559
Europe and Middle East	3,311	1,929
Asia	1,161	875
Other	1,519	1,113
Total	$ 25,222	$ 20,476

11. Customer Concentration

In the fiscal year ended September 30, 2011 and 2010, two distributors represented 50% and 54% of total revenue. At September 30, 2011 and 2010, these two distributors represented 68% and 57%, respectively of total accounts receivable.

Sonic Foundry, Inc.

Annual Report on Form 10-K

For the Year Ended September 30, 2011

12. Quarterly Financial Data (unaudited)

The following table sets forth selected quarterly financial information for the years ended September 30, 2011 and 2010. The operating results are not necessarily indicative of results for any future period.

	Quarterly Financial Data							
(in thousands except per share data)	**Q4- 11***	**Q3- 11**	**Q2- 11**	**Q1- 11**	**Q4- 10**	**Q3- 10**	**Q2- 10**	**Q1- 10**
Revenue	$ 6,677	$ 7,090	$ 5,525	$ 5,930	$ 5,439	$ 5,626	$ 4,909	$ 4,502
Gross margin	4,852	4,928	3,870	4,261	4,070	4,183	3,676	3,482
Gain (loss) from operations	(277)	361	(152)	346	236	330	(43)	(250)
Net income (loss)	(406)	212	(272)	223	126	203	(131)	(320)
Basic and diluted net income (loss) per share	$ (0.11)	$ 0.06	$ (0.07)	$ 0.06	$ 0.03	$ 0.06	$ (0.04)	$ (0.09)

* During Q4- 11, the company recognized $528 thousand of expense due to executive severance compensation triggered by the resignations of Rimas Buinevicius, former Executive Chairman of the Board, and Monty Schmidt, former Chief Technology Officer.

13. Subsequent Events

In October 2011, the Company paid the remaining balance of the Partners for Growth Term Loan.

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Sonic Foundry, Inc.

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For the Year Ended September 30, 2011

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

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Based on evaluations as of the end of the period covered by this report, our principal executive officer and principal financial officer, with the participation of our management team, have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e), and 15d-15(e) under the Securities Exchange Act) were effective.

Limitations on the effectiveness of Controls and Permitted Omission from Management s Assessment

Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. All internal control systems, no matter how well designed, have inherent limitations, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal controls can only provide reasonable assurance with respect to financial statement preparation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f).

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on this evaluation, our management believes that, as of September 30, 2011, our internal control over financial reporting was effective based on those criteria.

Changes in Internal Control Over Financial Reporting

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

ITEM 9B. OTHER INFORMATION

None.

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Sonic Foundry, Inc.

Annual Report on Form 10-K

For the Year Ended September 30, 2011

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE

The information required by Item 10 of Form 10-K with respect to directors and executive officers is incorporated herein by reference to the information contained in the section entitled Proposal One: Election of Directors and Executive Officers of Sonic , respectively, in the Company s definitive Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Company s 2011 Annual Meeting of Stockholders, which will be filed no later than January 28, 2012 (the Proxy Statement).

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

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

Item 407 of Regulation S-K calls for disclosure of whether or not the Company has an audit committee and a financial expert serving on the audit committee of the Board of Directors, and if so, who that individual is. Item 407 also requires disclosure regarding the Company s nominating committee and the director nomination process. This information is contained in the section entitled Meetings and Committees of Directors in the Proxy Statement and is incorporated herein by reference.

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

ITEM 11. EXECUTIVE COMPENSATION

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

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

The information required by Item 12 of Form 10-K is incorporated herein by reference to the information contained in the sections entitled Security Ownership of Certain Beneficial Owners and Management in the Proxy Statement. Information related to equity compensation plans is set forth in Item 5 herein.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS , AND DIRECTOR INDEPENDENCE

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

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Sonic Foundry, Inc.

Annual Report on Form 10-K

For the Year Ended September 30, 2011

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by Item 14 of Form 10-K is incorporated herein by reference to the information contained in the section entitled Ratification of Appointment of Independent Auditors Fiscal 2010 and 2011 Audit Fee Summary in the Proxy Statement.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(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 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.

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Sonic Foundry, Inc.

Annual Report on Form 10-K

For the Year Ended September 30, 2011

3.1	Articles of Amendment of Amended and Restated Articles of Incorporation, effective November 16, 2009, Amended and Restated Articles of Incorporation, effective January 26, 1998, and Articles of Amendment, effective April 9, 2000, filed as Exhibit No. 3.1 to the Annual Report on Form 10-K for the year ended September 30, 2009, and hereby incorporated by reference.
3.2	Amended and Restated By-Laws of the Registrant, filed as Exhibit No. 3.1 to the Form 8-K filed on October 11, 2011, and hereby incorporated by reference.
10.1*	Amended and Restated Employment Agreement between Registrant and Gary Weis dated as of September 30, 2011, filed as Exhibit 10.1 to the Form 8-K filed on October 4, 2011, and hereby incorporated by reference.
10.2*	Employment Agreement between Registrant and Rimas Buinevicius dated as of March 31, 2011, filed as Exhibit 10.1 to the form 8-K on April 4, 2011, and hereby incorporated by reference.
10.3*	Employment Agreement between Registrant and Gary Weis dated as of March 31, 2011, filed as Exhibit 10.2 to the Form 8-K filed on April 4, 2011, and hereby incorporated by reference.
10.4*	Consulting Agreement between Registrant and Monty R. Schmidt dated as of March 31, 2011, filed as Exhibit 10.3 to the Form 8-K filed on April 4, 2011, and hereby incorporated by reference.
10.5*	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.
10.6	Intellectual Property Security Agreement dated May 2, 2007, between Sonic Foundry, Inc. and Silicon Valley Bank filed as Exhibit 10.2 to the Form 8-K on May 7, 2007, and hereby incorporated by reference.
10.7	Intellectual Property Security Agreement dated May 2, 2007, between Sonic Foundry Media Systems, Inc. and Silicon Valley Bank filed as Exhibit 10.3 to Form 8-K on May 7, 2007, and hereby incorporated by reference.
10.8*	Employment Agreement dated October 31, 2007 between Sonic Foundry, Inc. and Kenneth A. Minor, filed as Exhibit 10.1 to the Form 8-K filed on November 2, 2007, and hereby incorporated by reference.
10.9	Amended and Restated Loan and Security Agreement dated June 16, 2008 and entered into as of June 16, 2008 among registrant, Sonic Foundry Media Services, Inc. and Silicon Valley Bank, filed as Exhibit 10.1 to the Form 8-K filed on June 20, 2008, and hereby incorporated by reference.
10.10*	Employment Agreement dated August 4, 2008 between Sonic Foundry, Inc. and Robert M. Lipps, filed as Exhibit 10.1 to the Form 8-K filed on August 6, 2008, and hereby incorporated by reference.
10.11	First Amendment to the Amended and Restated Loan and Security Agreement executed as of April 14, 2009 and effective as of April 1, 2009, among registrant, Sonic Foundry Media Systems, Inc. and Silicon Valley Bank, filed as Exhibit 10.1 to the Form 8-K filed on April 15, 2009, and hereby incorporated by reference.

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Sonic Foundry, Inc.

Annual Report on Form 10-K

For the Year Ended September 30, 2011

10.12*	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.
10.13*	Registrant s 2008 Non-Employee Directors Stock Option Plan filed as Exhibit B to Form 14A filed on January 28, 2008, and hereby incorporated by reference.
10.14*	Registrant s 2008 Employee Stock Purchase Plan filed as Exhibit C to Form 14A filed on January 28, 2008, and hereby incorporated by reference.
10.15*	Registrant s 2009 Stock Incentive Plan filed as Exhibit A to Form 14A filed on January 28, 2009, and hereby incorporated by reference.
10.16	Loan and Security Agreement executed as of March 5, 2010 among registrant, Sonic Foundry Media Systems, Inc., and Partners for Growth II, L.P., filed as Exhibit 10.1 to the Form 8-K filed on March 10, 2010, and hereby incorporated by reference.
10.17	Revolving Loan and Security Agreement executed as of March 5, 2010 among Registrant, Sonic Foundry Media Systems, Inc., and Partners for Growth II, L.P., filed as Exhibit 10.2 to the Form 8-K filed on March 10, 2010, and hereby incorporated by reference.
10.18	Warrant Purchase Agreement executed as of March 5, 2010 among registrant and Partners for Growth II, L.P., filed as Exhibit 10.3 to the Form 8-K filed on March 10, 2010, and hereby incorporated by reference.
10.19	Warrant executed as of March 5, 2010 among Registrant and Partners for Growth II, L.P., filed as Exhibit 10.4 to the Form 8-K filed on March 10, 2010, and hereby incorporated by reference.
10.20	Lease Agreement between Registrant, as tenant, and West Washington Associates, LLC as landlord, dated June 28, 2011, filed as Exhibit 10.1 to the Form 8-K filed on July 1, 2011, and hereby incorporated by reference.
10.21	Second Amended and Restated Loan and Security Agreement dated June 27, 2011 among Registrant, Sonic Foundry Media Systems, Inc. and Silicon Valley Bank, filed as Exhibit 10.2 to the Form 8-K filed on July 1, 2011, and hereby incorporated by reference.
10.22	Consent and Modification No. 1 to Loan and Security Agreement entered into as of June 28, 2011, among Partners for Growth II, L.P., Registrant and Sonic Foundry Media Systems, Inc. filed as Exhibit 10.3 to the Form 8-K filed on July 1, 2011, and hereby incorporated by reference.
21	List of Subsidiaries
23	Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer, Chief Accounting Officer and Secretary
32	Section 906 Certification of Chief Executive Officer and Chief Financial Officer, Chief Accounting Officer and Secretary

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Sonic Foundry, Inc.

Annual Report on Form 10-K

For the Year Ended September 30, 2011

101	The following materials from the Sonic Foundry, Inc. Form 10-K for the year ended September 30, 2011 formatted in Extensible Business Reporting Language (XBRL): (i) the Consolidated Statements of Operations, (ii) the Consolidated Balance Sheets, (iii) the Consolidated Statements of Stockholder s Equity, (iv) the Consolidated Statements of Cash Flows and (v) related notes, tagged as blocks of text.

* Compensatory Plan or Arrangement

(b) Exhibits See exhibit index in Item 15(a)3 of this Report.

(c) Financial Statement Schedule see Item 15(a)2 of this Report

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Sonic Foundry, Inc.

Annual Report on Form 10-K

For the Year Ended September 30, 2011

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.

Sonic Foundry, Inc.

(Registrant)

By: /s/ Gary R. Weis
Gary R. Weis
Chairman and Chief Executive Officer

Date: November 22, 2011

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.

Signature	Title	Date
/s/ Gary R. Weis	Chief Executive Officer and Director	November 22, 2011
/s/ Kenneth A. Minor	Chief Financial Officer, Chief Accounting Officer and Secretary	November 22, 2011
/s/ Mark D. Burish	Chair and Director	November 22, 2011
/s/ Michael H. Janowiak	Director	November 22, 2011
/s/ David C. Kleinman	Director	November 22, 2011
/s/ Frederick H. Kopko, Jr.	Director	November 22, 2011
/s/ Paul S. Peercy	Director	November 22, 2011

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Sonic Foundry, Inc.

Annual Report on Form 10-K

For the Year Ended September 30, 2011

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

(In thousands)

	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Deductions Write-offs	Balance at End of Period
Year ended September 30, 2011				
Accounts receivable reserve	$ 105	$ 1	$ 16	$ 90
Year ended September 30, 2010				
Accounts receivable reserve	$ 105	$ 29	$ 29	$ 105
Year ended September 30, 2009				
Accounts receivable reserve	$ 150	$ 7	$ 52	$ 105

74

">

2016

2015

2014

(In Thousands)
Net income

$
14,909

$
16,514

$
14,139

Other comprehensive (loss) income, before tax

Securities available-for-sale:

Unrealized securities (losses) gains arising during the period

(912
)

(719
)

1,619

Securities held-to-maturity:

Unrealized losses transferred during the period

—

—

(874
)
Amortization of net unrealized losses transferred from available-for-sale

159

233

167

Income tax benefit (expense)

311

188

(352
)
Total other comprehensive (loss) income

(442
)

(298
)

560

Comprehensive income

$
14,467

$
16,216

$
14,699

See accompanying Notes to Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Changes in Stockholders’ Equity

	Common Shares Outstanding	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
	(In Thousands, Except Share Data)						
Balance at December 31, 2013	7,887,994	$ 41	$ 56,002	$ 57,143	$ (342)	$ (3,569)	$ 109,275
Net income	—	—	—	14,139	—	—	14,139
Other comprehensive income	—	—	—	—	560	—	560
Issuance of common stock	720,162	3	16,554	—	—	—	16,557
Exercise of stock options	78,000	1	936	—	—	—	937
Share-based compensation - restricted shares	64,522	—	887	—	—	—	887
Share-based compensation - tax benefits	—	—	584	—	—	—	584
Cash dividends ($0.42 per share)	—	—	—	(3,396)	—	—	(3,396)
Treasury stock purchased	(78,824)	—	—	—	—	(1,795)	(1,795)
Balance at December 31, 2014	8,671,854	$ 45	$ 74,963	$ 67,886	$ 218	$ (5,364)	$ 137,748
Net income	—	—	—	16,514	—	—	16,514
Other comprehensive loss	—	—	—	—	(298)	—	(298)
Common stock dividends	—	44	(44)	—	—	—	—
Exercise of stock options	24,000	—	300	—	—	—	300
Share-based compensation - restricted shares	45,347	—	1,063	—	—	—	1,063
Share-based compensation - tax benefits	—	—	267	—	—	—	267
Cash dividends ($0.44 per share)	—	—	—	(3,816)	—	—	(3,816)
Treasury stock purchased	(41,791)	—	—	—	—	(946)	(946)
Balance at December 31, 2015	8,699,410	$ 89	$ 76,549	$ 80,584	$ (80)	$ (6,310)	$ 150,832
Net income	—	—	—	14,909	—	—	14,909
Other comprehensive loss	—	—	—	—	(442)	—	(442)
Share-based compensation - restricted shares	36,864	1	993	—	—	—	994
Cash dividends ($0.48 per share)	—	—	—	(4,176)	—	—	(4,176)
Treasury stock purchased	(20,418)	—	—	—	—	(467)	(467)
Balance at December 31, 2016	8,715,856	$ 90	$ 77,542	$ 91,317	$ (522)	$ (6,777)	$ 161,650

See accompanying Notes to Consolidated Financial Statements.

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First Business Financial Services, Inc.
Consolidated Statements of Cash Flows

	For the Year Ended December 31,		
	2016	2015	2014
	(In Thousands)		
Operating activities			
Net income	$14,909	$16,514	$14,139
Adjustments to reconcile net income to net cash provided by operating activities:			
Deferred income taxes, net	(1,108)	1,158	1,389
Impairment of tax credit investments	3,691	—	—
Provision for loan and lease losses	7,818	3,386	1,236
Depreciation, amortization and accretion, net	1,515	(90)	1,870
Share-based compensation	994	1,063	887
Gain on sale of available-for-sale securities	(10)	—	—
Increase in value of bank-owned life insurance policies	(974)	(960)	(862)
Origination of loans for sale	(71,965)	(70,254)	(9,392)
Sale of loans originated for sale	78,546	77,333	6,651
Gain on sale of loans originated for sale	(4,990)	(4,728)	(392)
Net loss (gain) on foreclosed properties, including impairment valuation	122	(171)	(10)
Excess tax benefit from share-based compensation	(142)	—	—
Returns on investments in limited partnerships	250	—	—
Increase in accrued interest receivable and other assets	(3,861)	(1,033)	(5,448)
Increase in accrued interest payable and other liabilities	1,367	1,002	1,806
Net cash provided by operating activities	26,162	23,220	11,874
Investing activities			
Proceeds from maturities, redemptions and paydowns of available-for-sale securities	43,745	42,899	44,148
Proceeds from maturities, redemptions and paydowns of held-to-maturity securities	3,882	4,349	2,211
Proceeds from sale of available-for-sale securities	5,227	—	—
Purchases of available-for-sale and held-to-maturity securities	(61,547)	(40,721)	(52,947)
Proceeds from sale of foreclosed properties	83	528	255
Net increase in loans and leases	(22,385)	(155,204)	(299,095)
Net cash associated with the Alterra Bank acquisition	—	—	(11,957)
Investments in limited partnerships	(750)	—	(1,000)
Returns of investments in limited partnerships	541	459	722
Investment in community development entity	—	—	(7,500)
Investment in historic development entities	(3,456)	(578)	—
Investment in Federal Home Loan Bank and Federal Reserve Bank Stock	(1,308)	(1,352)	(1,459)
Proceeds from the sale of Federal Home Loan Bank Stock	2,020	849	373
Purchases of leasehold improvements and equipment, net	(584)	(789)	(3,190)
Purchases of bank owned life insurance policies	(9,750)	—	(3,285)
Premium payment on bank owned life insurance policies	(26)	(25)	(25)
Net cash used in investing activities	(44,308)	(149,585)	(332,749)
Financing activities			
Net (decrease) increase in deposits	(38,256)	139,469	308,413
Repayment of Federal Home Loan Bank advances	(4,500)	(1,000)	—
Proceeds from Federal Home Loan Bank advances	30,000	—	9,383
Net (decrease) increase in short-term borrowed funds	(1,500)	1,500	1,000
Net increase in long-term borrowed funds	998	918	675

Proceeds from issuance of subordinated notes payable, net of issuance costs	—	—	14,469
Repayment of subordinated notes payable	—	—	(4,000)
Excess tax benefit from share-based compensation	—	267	584
Common stock issuance	—	—	16,557
Cash dividends paid	(4,176)	(3,816)	(3,396)

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First Business Financial Services, Inc.
Consolidated Statements of Cash Flows

	For the Year Ended December 31,		
	2016	2015	2014
	(In Thousands)		
Exercise of stock options	—	300	936
Purchase of treasury stock	(467)	(946)	(1,795)
Net cash (used in) provided by financing activities	(17,901)	136,692	342,826
Net (decrease) increase in cash and cash equivalents	(36,047)	10,327	21,951
Cash and cash equivalents at the beginning of the period	113,564	103,237	81,286
Cash and cash equivalents at the end of the period	$77,517	$113,564	$103,237
Supplementary cash flow information			
Cash paid during the period for:			
Interest paid on deposits and borrowings	$14,790	$13,639	$11,048
Income taxes paid	5,554	5,668	7,221
Non-cash investing and financing activities:			
Transfer of securities from available-for-sale to held-to-maturity	—	—	44,587
Transfer of loans from held-to-maturity to held-for-sale	11,504	4,336	—
Unrealized loss on transfer of securities from available-for-sale to held-to-maturity	—	—	(874)

See accompanying Notes to Consolidated Financial Statements.

First Business Financial Services, Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Note 1 – Nature of Operations and Summary of Significant Accounting Policies
Nature of Operations. The accounting and reporting practices of First Business Financial Services, Inc. (the "Corporation"), its wholly-owned subsidiaries, First Business Bank ("FBB"), First Business Bank – Milwaukee ("FBB – Milwaukee") and Alterra Bank ("Alterra") have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). FBB, FBB – Milwaukee and Alterra are sometimes referred to together as the "Banks." FBB operates as a commercial banking institution in the Madison, Wisconsin market, consisting primarily of Dane County and the surrounding areas, with three loan production offices in Northeast Wisconsin. FBB also offers trust and investment services through First Business Trust & Investments ("FBTI"), a division of FBB. FBB – Milwaukee operates as a commercial banking institution in the Milwaukee, Wisconsin market, consisting primarily of Waukesha County and the surrounding areas, with a loan production office in Kenosha, Wisconsin. Alterra operates as a commercial banking institution in the Kansas City market and the surrounding areas. The Banks provide a full range of financial services to businesses, business owners, executives, professionals and high net worth individuals. The Banks are subject to competition from other financial institutions and service providers and are also subject to state and federal regulations. FBB has the following wholly-owned subsidiaries: First Business Capital Corp. ("FBCC"), First Madison Investment Corp. ("FMIC"), First Business Equipment Finance, LLC ("FBEF"), Rimrock Road Investment Fund, LLC ("Rimrock Road"), BOC Investment, LLC ("BOC") and Mitchell Street Apartments Investment, LLC ("Mitchell Street"). FMIC is located in and was formed under the laws of the State of Nevada. FBB-Milwaukee has one subsidiary, FBB – Milwaukee Real Estate, LLC ("FBBMRE").
Basis of Financial Statement Presentation. The Consolidated Financial Statements include the accounts of the Corporation and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. In accordance with the provisions of Accounting Standards Codification ("ASC") Topic 810, the Corporation's ownership interest in FBFS Statutory Trust II ("Trust II") has not been consolidated into the financial statements.
Management of the Corporation is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that could significantly change in the near-term include the value of securities, level of the allowance for loan and lease losses, lease residuals, property under operating leases, goodwill, level of the Small Business Administration ("SBA") recourse reserve and income taxes. Certain amounts in prior periods may have been reclassified to conform to the current presentation. Subsequent events have been evaluated through the date of the issuance of the Consolidated Financial Statements. No significant subsequent events have occurred through this date requiring adjustment to the financial statements or disclosures.
Cash and Cash Equivalents. The Corporation considers federal funds sold, interest-bearing deposits and short-term investments that have original maturities of three months or less to be cash equivalents.
Securities. The Corporation classifies its investment and mortgage-related securities as available-for-sale, held-to-maturity and trading. Debt securities that the Corporation has the positive intent and ability to hold to maturity are classified as held-to-maturity and are stated at amortized cost. Debt and equity securities bought expressly for the purpose of selling in the near term are classified as trading securities and are measured at fair value with unrealized gains and losses reported in earnings. Debt and equity securities not classified as held-to-maturity or as trading are classified as available-for-sale. Available-for-sale securities are measured at fair value with unrealized gains and losses reported as a separate component of stockholders' equity, net of tax. Realized gains and losses, and declines in value deemed to be other than temporary, are included in the consolidated statements of income as a component of non-interest income. The cost of securities sold is based on the specific identification method. The Corporation did not hold any trading securities at December 31, 2016 or 2015.
Discounts and premiums on securities are accreted and amortized into interest income using the effective yield method over the weighted average life of the securities.

Declines in the fair value of investment securities (with certain exceptions for debt securities noted below) that are deemed to be other-than-temporary are charged to earnings as a realized loss and a new cost basis for the securities is established. In evaluating other-than-temporary impairment, management considers the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer and the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. Declines in the fair value of debt securities below amortized cost are deemed to be other-than-temporary in circumstances where: (1) the Corporation has the intent to sell a security; (2) it is more likely than not that the Corporation will be required to sell the security before recovery of its amortized cost basis; or (3) the Corporation does not expect to recover the entire amortized cost basis of the security. If the Corporation intends to sell a security or if it is more likely than not that the Corporation will be required to sell the security before recovery, an other-than-temporary impairment write-down is recognized in earnings equal to the difference between the security's amortized cost basis and its fair value. If the Corporation does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into an amount representing credit loss, which is recognized in earnings, and an amount related to all other factors, which is recognized in other comprehensive income.

Loans Held for Sale. Residential real estate loans and the guaranteed portion of SBA loans which are originated and intended for sale in the secondary market in the foreseeable future are classified as held for sale. These loans are carried at the lower of cost or fair value in the aggregate. Unrealized losses on such loans are recognized through a valuation allowance by a charge to other non-interest income. Gains and losses on the sale of loans are also included in other non-interest income. As assets specifically originated for sale, the origination of, disposition of, and gain/loss on these loans are classified as operating activities in the statement of cash flows. Fees received from the borrower and direct costs to originate the loan are deferred and recognized as part of the gain or loss on sale. There was $1.1 million and $2.7 million in loans held for sale outstanding at December 31, 2016 and 2015, respectively.

Loans and Leases. Loans and leases which management has the intent and ability to hold for the foreseeable future or until maturity are reported at their outstanding principal balance with adjustments for partial charge-offs, the allowance for loan and lease losses, deferred fees or costs on originated loans and leases and unamortized premiums or discounts on any purchased loans.

A loan or a lease is accounted for as a troubled debt restructuring if the Corporation, for economic or legal reasons related to the borrower's financial condition, grants a concession to the borrower that it would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan or lease or a modification of terms, such as a reduction of the stated interest rate or face amount of the loan or lease, a reduction of accrued interest, an extension of the maturity date at a stated interest rate lower than the current market rate for a new loan or lease with similar risk or some combination of these concessions. Restructured loans can involve loans remaining on non-accrual, moving to non-accrual or continuing on accrual status, depending on individual facts and circumstances. Non-accrual restructured loans are included and treated with all other non-accrual loans. In addition, all accruing restructured loans are reported as troubled debt restructurings which are considered and accounted for as impaired loans. Generally, restructured loans remain on non-accrual until the borrower has attained a sustained period of repayment performance under the modified loan terms (generally a minimum of six months). However, performance prior to the restructuring, or significant events that coincide with the restructuring, are considered in assessing whether the borrower can meet the new terms and whether the loan should be returned to or maintained on accrual status. If the borrower's ability to meet the revised payment schedule is not reasonably assured, the loan remains on non-accrual.

Interest on non-impaired loans and leases is accrued and credited to income on a daily basis based on the unpaid principal balance and is calculated using the effective interest method. Per policy, a loan or a lease is considered impaired and placed on a non-accrual status when it becomes 90 days past due or it is doubtful that contractual principal and interest will be collected in accordance with the terms of the contract. A loan or lease is determined to be past due if the borrower fails to meet a contractual payment and will continue to be considered past due until all contractual payments are received. When a loan or lease is placed on non-accrual, the interest accrual is discontinued and previously accrued but uncollected interest is deducted from interest income. If collectability of the contractual principal and interest is in doubt, payments received are first applied to reduce the loan principal. If collectability of the contractual payments is not in doubt, payments may be applied to interest for interest amounts due on a cash basis. As soon as it is determined with certainty that the principal of an impaired loan or lease is uncollectable, either through collections from the borrower or disposition of the underlying collateral, the portion of the carrying balance that exceeds the estimated measurement value of the loan or lease is charged off. Loans or leases are returned to accrual status when they are brought current in terms of both principal and accrued interest due, have performed in accordance with contractual terms for a reasonable period of time and when the ultimate collectability of total contractual principal and interest is no longer doubtful.

Transfers of assets, including but not limited to the guaranteed portion of SBA loans and participation interests in other originated loans, that upon completion of the transfer satisfy the conditions to be reported as a sale, including legal isolation, are derecognized from the Consolidated Financial Statements. Transfers of assets that upon completion of the transfer do not meet the conditions of a sale are recorded on a gross basis with a secured borrowing identified to reflect the amount of the transferred interest.

Loan and lease origination fees as well as certain direct origination costs are deferred and amortized as an adjustment to loan yields over the stated term of the loan or lease. Loans or leases that result from a refinance or restructuring, other than a troubled debt restructuring, where terms are at least as favorable to the Corporation as the terms for comparable loans to other borrowers with similar collection risks and result in an essentially new loan or lease, are accounted for as a new loan or lease.

Any unamortized net fees, costs or penalties are recognized when the new loan or lease is originated. Unamortized net loan or lease fees or costs for loans and leases that result from a refinance or restructure with only minor modifications to the original loan or lease contract are carried forward as a part of the net investment in the new loan or lease. For troubled debt restructurings, all fees received in connection with a modification of terms are applied as a reduction of the loan or lease and any related costs, including direct loan origination costs, are charged to expense as incurred.

The Corporation purchased an individual loan in 2013 and a group of loans in connection with the Alterra acquisition which have shown evidence of credit deterioration since origination. These purchased loans are recorded at fair value, such that there is no carryover of the seller's allowance for loan losses. Such purchased loans are accounted for individually. At acquisition, the Corporation estimates the amount and timing of expected cash flows for each purchased loan and the expected cash flows in excess of fair value are recorded as interest income over the remaining life of the loan (accretable yield). The excess of the loan's contractual principal and interest over expected cash flows at acquisition is not recorded (nonaccretable difference).

Over the life of the loan, expected cash flows continue to be estimated. If the present value of expected cash flows is less than the carrying amount, losses are recognized by an increase in the allowance for loan losses. If the present value of expected cash flows is greater than the carrying amount, it is recognized as part of future interest income.

Allowance for Loan and Lease Losses. The allowance for loan and lease losses is maintained at a level that management deems appropriate to absorb probable and estimable losses inherent in the loan and lease portfolios. The methodology applied for determining inherent losses stems from current risk characteristics of the loan and lease portfolio, an assessment of individual impaired loans and leases, actual loss experience and adverse situations that may affect the borrower's ability to repay. The methodology also focuses on evaluation of several factors for each portfolio category, including but not limited to: management's ongoing review and grading of the loan and lease portfolios, consideration of delinquency experience, changes in the size of the loan and lease portfolios, existing economic conditions, level of loans and leases subject to more frequent review by management, changes in underlying collateral, concentrations of loans to specific industries and other qualitative and quantitative factors that could affect credit losses. Some impaired and other loans and leases have risk characteristics that are unique to an individual borrower and the loss must be estimated on an individual basis. Other impaired and problem loans and leases may have risk characteristics similar to other loans and leases and bear similar inherent risk of loss. Such loans and leases, which are not individually reviewed and measured for impairment, are aggregated and historical loss statistics are used to determine the risk of loss.

The measurement of the estimate of loss is reliant upon historical experience, information about the ability of the individual debtor to pay and the appraisal of loan collateral in light of current economic conditions. An estimate of loss is an approximation of what portion of all amounts receivable, according to the contractual terms of that receivable, is deemed uncollectible. Determination of the allowance is inherently subjective because it requires estimation of amounts and timing of expected future cash flows on impaired loans and leases, estimation of losses on types of loans and leases based on historical losses and consideration of current economic trends, both local and national. Based on management's periodic review using all previously mentioned pertinent factors, a provision for loan and lease losses is charged to expense when it is determined an increase in the allowance for loan and lease losses is appropriate. A negative provision for loan and lease losses may be recognized if management determines a reduction in the level of allowance for loan and lease losses is appropriate. Loan and lease losses are charged against the allowance and recoveries are credited to the allowance.

The allowance for loan and lease losses contains specific allowances established for expected losses on impaired loans and leases. Impaired loans and leases are defined as loans and leases for which, based on current information and events, it is probable that the Corporation will be unable to collect scheduled principal and interest payments according to the contractual terms of the loan or lease agreement. Loans and leases subject to impairment are defined as non-accrual and restructured loans and leases.

Impaired loans and leases are evaluated on an individual basis to determine the amount of specific reserve or charge-off required, if any. Smaller balance (individually less than $50,000) loans and leases are collectively evaluated for impairment as allowed under applicable accounting standards.

The measurement value of impaired loans and leases is determined based on the present value of expected future cash flows discounted at the loan's effective interest rate (the contractual interest rate adjusted for any net deferred loan fees or costs, premium or discount existing at the origination or acquisition of the loan), the market price of the loan or lease or the fair value of the underlying collateral less costs to sell, if the loan or lease is collateral dependent. A loan or lease is collateral dependent if repayment is expected to be provided principally by the underlying collateral. A loan's effective interest rate may change over the life of the loan based on subsequent changes in rates or indices or may be fixed at the rate in effect at the date the loan was determined to be impaired.

Subsequent to the initial impairment, any significant change in the amount or timing of an impaired loan or lease's future cash flows will result in a reassessment of the valuation allowance to determine if an adjustment is necessary. Measurements based on observable market price or fair value of the collateral may change over time and require a reassessment of the allowance if there is a significant change in either measurement base. Any increase in the present value of expected future cash flows attributable to the passage of time is recorded as interest income accrued on the net carrying amount of the loan or lease at the effective interest rate used to discount the impaired loan or lease's estimated future cash flows. Any change in present value attributable to changes in the amount or timing of expected future cash flows is recorded as loan loss expense in the same manner in which impairment was initially recognized or as a reduction of loan loss expense that otherwise would be reported. Where the level of loan or lease impairment is measured using observable market price or fair value of collateral, any change in the observable market price of an impaired loan or lease or fair value of the collateral of an impaired collateral-dependent loan or lease is recorded as loan loss expense in the same manner in which impairment was initially recognized. Any increase in the observable market value of the impaired loan or lease or fair value of the collateral in an impaired collateral-dependent loan or lease is recorded as a reduction in the amount of loan loss expense that otherwise would be reported.

Net Investment in Direct Financing Leases. The net investment in direct financing lease agreements represents total undiscounted payments plus estimated unguaranteed residual value (approximating 3% to 20% of the cost of the related equipment) and is recorded as lease receivables when the lease is signed and the leased property is delivered to the client. The excess of the minimum lease payments and residual values over the cost of the equipment is recorded as unearned lease income. Unearned lease income is recognized over the term of the lease on a basis which results in an approximate level rate of return on the unrecovered lease investment. Lease payments are recorded when due under the lease contract. Residual values are established at lease inception equal to the estimated value to be received from the equipment following termination of the initial lease and such estimated value considers all relevant information and circumstances regarding the equipment. In estimating the equipment's fair value at lease termination, the Corporation relies on internally or externally prepared appraisals, published sources of used equipment prices and historical experience adjusted for known current industry and economic trends. The Corporation's estimates are periodically reviewed to ensure reasonableness; however, the amounts the Corporation will ultimately realize could differ from the estimated amounts. When there are other than temporary declines in the Corporation's carrying amount of the unguaranteed residual value, the carrying value is reduced and charged to non-interest expense.

Operating Leases. Machinery and equipment are leased to clients under operating leases and are recorded at cost. Equipment under such leases is depreciated over the estimated useful life or term of the lease, if shorter. The impairment loss, if any, would be charged to expense in the period it becomes evident. Rental income is recorded on the straight-line accrual basis as other non-interest income.

Premises and Equipment, net. The cost of buildings and capitalized leasehold improvements is amortized on the straight-line method over the lesser of the term of the respective lease or estimated economic life. Equipment is stated at cost less accumulated depreciation and amortization which is calculated by the straight-line method over the estimated useful lives of three to ten years. Maintenance and repair costs are charged to expense as incurred. Improvements which extend the useful life are capitalized and depreciated over the remaining useful life of the assets.

Foreclosed Properties. Property acquired by repossession, foreclosure or by deed in lieu of foreclosure is carried at the lower of the recorded investment in the loan at the time of acquisition or the fair value of the underlying property, less costs to sell. Any write-down in the carrying value of a loan or lease at the time of acquisition is charged to the allowance for loan and lease losses. Any subsequent write-downs to reflect current fair value, as well as gains and losses on disposition and revenues are recorded in non-interest expense. Costs relating to the development and improvement of the property are capitalized while holding period costs are charged to other non-interest expense.

Bank-Owned Life Insurance. Bank-owned life insurance ("BOLI") is reported at the amount that would be realized if the life insurance policies were surrendered on the balance sheet date. BOLI policies owned by the Banks are purchased with the objective to fund certain future employee benefit costs with the death benefit proceeds. The cash surrender value of such policies is recorded in bank-owned life insurance on the Consolidated Balance Sheets and changes in the value are recorded in non-interest income. The total death benefit of all of the BOLI policies was $97.3 million and $67.1 million as of December 31, 2016 and 2015, respectively. There are no restrictions on the use of BOLI proceeds nor are there any contractual restrictions on the ability to surrender the policy. As of each of December 31, 2016 and 2015, there were no borrowings against the cash surrender value of the BOLI policies.

Federal Home Loan Bank and Federal Reserve Bank Stock. The Banks are required to maintain Federal Home Loan Bank (“FHLB”) stock as members of the FHLB, and in amounts as required by these institutions. Alterra, as a state chartered member of the Federal Reserve Bank of Kansas City, is required to own shares of Federal Reserve Bank (“FRB”) stock. These equity securities are “restricted” in that they can only be sold back to the respective institutions or another member institution at par. Therefore, they are less liquid than other marketable equity securities and their fair value is equal to cost. At December 31, 2016 and 2015, the Banks had FHLB stock of $1.1 million and $1.8 million, respectively. Alterra had FRB stock of $1.1

million at December 31, 2016 and 2015. The Corporation periodically evaluates its holding in FHLB and FRB stock for impairment. Should the stock be impaired, it would be written down to its estimated fair value. There were no impairments recorded on FHLB and FRB stock during the year ended December 31, 2016 or 2015.

Goodwill and Other Intangible Assets. Goodwill and other intangible assets consist primarily of goodwill, core deposit intangibles and loan servicing rights. Core deposit intangibles have estimated finite lives and are amortized on an accelerated basis to expense over a period of seven years. Loan servicing rights, when purchased, are initially recorded at fair value and subsequently amortized in proportion to and over the period of estimated net servicing income. The Corporation reviews other intangible assets for impairment at least annually, or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, in which case an impairment charge would be recorded.

Goodwill is not amortized but is subject to impairment tests on at least an annual basis, and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount (including goodwill). An initial qualitative evaluation is made to assess the likelihood of impairment and determine whether further quantitative testing to calculate the fair value is necessary. When the qualitative evaluation indicates that impairment is more likely than not, quantitative testing is required whereby the fair value of each reporting unit is calculated and compared to the recorded book value, "step one." If the calculated fair value of the reporting unit exceeds its carrying value, goodwill is not considered impaired and "step two" is not considered necessary. If the carrying value of a reporting unit exceeds its calculated fair value, the impairment test continues ("step two") by comparing the carrying value of the reporting unit's goodwill to the implied fair value of goodwill. The implied fair value is computed by adjusting all assets and liabilities of the reporting unit to current fair value with the offset adjustment to goodwill. The adjusted goodwill balance is the implied fair value of the goodwill. An impairment charge is recognized if the carrying value of goodwill exceeds the implied fair value of goodwill. See Note 6 for additional information on goodwill and other intangible assets.

SBA Recourse Reserve. The Corporation establishes SBA recourse reserves on the guaranteed portion of sold SBA loans when it is probable that the guarantee may be ineligible. The recourse reserve is reported in accrued interest payable and other liabilities on the Consolidated Balance Sheets and consists of two components: (1) specific reserves for individually evaluated impaired loans that present a collateral shortfall where the guaranty associated with the sold portion of the SBA loan is determined to most likely be ineligible; and (2) general reserves for estimated probable losses on the remaining sold portfolio. The general reserve methodology is based on the evaluation of several factors, including but not limited to: credit quality trends within the SBA portfolio, changes in underlying collateral and the Corporation's ability to originate, fund or service sold SBA loans in accordance with SBA regulations.

In the ordinary course of business, the Corporation sells the guaranteed portion of SBA loans to third parties. The Corporation has a continuing involvement in each of the transferred lending arrangements by way of relationship management, servicing the loans, as well as being subject to normal and customary requirements of the SBA loan program; however, there are no further obligations to the third-party participant required of the Corporation, other than standard representations and warranties related to sold amounts. In the event of a loss resulting from default and a determination by the SBA that there is a deficiency in the manner in which the loan was originated, funded or serviced by the Corporation, the SBA may require the Corporation to repurchase the loan, deny its liability under the guaranty, reduce the amount of the guaranty, or, if it has already paid under the guaranty, seek recovery of the principal loss related to the deficiency from the Corporation. The Corporation must comply with applicable SBA regulations in order to maintain the guaranty. In addition, the Corporation retains the option to repurchase the sold guaranteed portion of an SBA loan if the loan defaults. See Note 18 for additional information on the SBA recourse reserve.

Other Investments. The Corporation owns certain equity investments in other corporate organizations which are not consolidated because the Corporation does not own more than a 50% interest or exercise control over the organization. Investments in corporations representing at least a 20% interest are generally accounted for using the equity method and investments in corporations representing less than 20% interest are generally accounted for at cost. Investments in limited partnerships representing from at least a 3% up to a 50% interest in the entity are generally accounted for using the equity method and investments in limited partnerships representing less than 3% are generally accounted for at cost. All of these investments are periodically evaluated for impairment. Should an investment be impaired, it would be written down to its estimated fair value. The equity investments are reported in other assets and the income and expense from such investments, if any, is reported in non-interest income and non-interest expense. Derivative Instruments. The Corporation uses derivative instruments to protect against the risk of adverse price or interest rate movements on the value of certain assets, liabilities, future cash flows and economic hedges for written client derivative contracts. Derivative instruments represent contracts between parties that usually require little or no initial net investment and result in one party delivering cash to the other party based on a notional amount and an underlying as specified in the contract and may be subject to master netting agreements. A notional amount represents the number of units of a specific item, such as

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currency units. An underlying represents a variable, such as an interest rate. The amount of cash delivered from one party to the other is determined based on the interaction of the notional amount of the contract with the underlying. Market risk is the risk of loss arising from an adverse change in interest rates, exchange rates or equity prices. The Corporation's primary market risk is interest rate risk. Instruments designed to manage interest rate risk include interest rate swaps, interest rate options and interest rate caps and floors with indices that relate to the pricing of specific assets and liabilities. The nature and volume of the derivative instruments used to manage interest rate risk depend on the level and type of assets and liabilities on the balance sheet and the risk management strategies for the current and anticipated rate environments. Counterparty risk with respect to derivative instruments occurs when a counterparty to a derivative contract with an unrealized gain fails to perform according to the terms of the agreement. Counterparty risk is managed by limiting the counterparties to highly rated dealers, requiring collateral postings when values are in deficit positions, applying uniform credit standards to all activities with credit risk and monitoring the size and the maturity structure of the derivative portfolio.

All derivative instruments are to be carried at fair value on the Consolidated Balance Sheets. The accounting for the gain or loss due to changes in the fair value of a derivative instrument depends on whether the derivative instrument qualifies as a hedge. If the derivative instrument does not qualify as a hedge, the gains or losses are reported in earnings when they occur. However, if the derivative instrument qualifies as a hedge, the accounting varies based on the type of risk being hedged. In 2016 and 2015, the Corporation solely utilized interest rate swaps which did not qualify for hedge accounting, and therefore, all changes in fair value and gains and losses on these instruments were reported in earnings as they occurred. The effects of netting arrangements are disclosed within the Notes of the Consolidated Financial Statements.

Income Taxes. Deferred income tax assets and liabilities are computed annually for temporary differences in timing between the financial statement and tax basis of assets and liabilities that result in taxable or deductible amounts in the future based on enacted tax law and rates applicable to periods in which the differences are expected to affect taxable income. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the ability to carry back any losses to previous years with taxable income, scheduled reversals of deferred tax liabilities, appropriate tax planning strategies and projections for future taxable income over the period which the deferred tax assets are deductible. When necessary, valuation allowances are established to reduce deferred tax assets to the realizable amount. Management believes it is more likely than not that the Corporation will realize the benefits of these deductible differences, net of the existing valuation allowances.

Income tax expense or benefit represents the tax payable or tax refundable for a period, adjusted by the applicable change in deferred tax assets and liabilities for that period. The Corporation and its subsidiaries file a consolidated federal income tax return and separate state income tax returns. Tax sharing agreements allocate taxes to each entity for the settlement of intercompany taxes. The Corporation applies a more likely than not standard to each of its tax positions when determining the amount of tax expense or benefit to record in its financial statements. Unrecognized tax benefits are recorded in other liabilities. The Corporation recognizes accrued interest relating to unrecognized tax benefits in income tax expense and penalties in other non-interest expense.

Other Comprehensive Income or Loss. Comprehensive income or loss, shown as a separate financial statement, includes net income or loss, changes in unrealized holding gains and losses on available-for-sale securities, changes in deferred gains and losses on investment securities transferred from available-for-sale to held-to-maturity, if any, changes in unrealized gains and losses associated with cash flow hedging instruments, if any, and the amortization of deferred gains and losses associated with terminated cash flow hedges, if any. For the year ended December 31, 2016, there were no items requiring reclassification out of accumulated other comprehensive income.

Earnings Per Common Share. Earnings per common share ("EPS") is computed using the two-class method. Basic EPS is computed by dividing net income allocated to common shares by the weighted average number of common shares outstanding for the period, excluding any participating securities. Participating securities include unvested restricted shares. Unvested restricted shares are considered participating securities because holders of these securities receive non-forfeitable dividends at the same rate as the holders of the Corporation's common stock. Diluted EPS is computed by dividing net income allocated to common shares adjusted for reallocation of undistributed earnings of unvested restricted shares by the weighted average number of common shares determined for the basic EPS plus the dilutive effect of common stock equivalents using the treasury stock method based on the average market price for the period. Some stock options are anti-dilutive and therefore are not included in the calculation of diluted EPS.

Segments and Related Information. The Corporation is required to report each operating segment based on materiality thresholds of ten percent or more of certain amounts, such as revenue. Additionally, the Corporation is required to report separate operating segments until the revenue attributable to such segments is at least 75 percent of total consolidated revenue. The Corporation provides a broad range of financial services to individuals and companies in the Midwest. These services include demand, time and savings products, the sale of certain non-deposit financial products and commercial and retail

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lending, leasing and trust services. While the Corporation's chief decision-maker monitors the revenue streams of the various products, services and locations, operations are managed and financial performance is evaluated on a corporate-wide basis. The Corporation's business units have similar basic characteristics in the nature of the products, production processes and type or class of client for products or services; therefore, these business units are considered one operating segment.

Share-Based Compensation. As noted below within the "Recent Accounting Pronouncements" section, the Corporation early adopted ASU No. 2016-09 on October 1, 2016 with an effective date of January 1, 2016. Upon vesting of restricted share awards subject to ASU No. 2016-09, the benefit of tax deductions in excess of recognized compensation expense is reflected as an income tax benefit in the Consolidated Statements of Income. Excess tax benefits are included in other operating activities and taxes paid related to net share settlement of equity awards in financing activities within the Consolidated Statements of Cash Flows. The Corporation elected to account for forfeitures as they occur. While restricted stock is subject to forfeiture, with the exception of restricted stock units, which do not have voting rights and are provided dividend equivalents, restricted stock participants may exercise full voting rights and will receive all dividends and other distributions paid with respect to the restricted shares. The restricted stock granted under the Plan is typically subject to a vesting period. Compensation expense is recognized over the requisite service period of generally four years for the entire award on a straight-line basis. See Note 12 for additional information on share-based compensation.

Recent Accounting Pronouncements. In February 2015, the Financial Accounting Standards Board ("FASB") issued ASU No. 2015-02, "Consolidation (Topic 810): Amendments to the Consolidation Analysis." This ASU changes the way reporting enterprises evaluate whether (a) they should consolidate limited partnerships and similar entities, (b) fees paid to a decision maker or service provider are variable interests in a variable interest entity ("VIE"), and (c) variable interests in a VIE held by related parties of the reporting enterprise require the reporting enterprise to consolidate the VIE. It also eliminates the VIE consolidation model based on majority exposure to variability that applied to certain investment companies and similar entities. The new guidance excludes money market funds that are required to comply with Rule 2a-7 of the Investment Company Act of 1940 and similar entities from the U.S. GAAP consolidation requirements. The new consolidation guidance is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015. At the effective date, all previous consolidation analysis that the guidance affects must be reconsidered. This includes the consolidation analysis for all VIEs and for all limited partnerships and similar entities that previously were consolidated by the general partner even though the entities were not VIEs. The Corporation adopted the standard during the first quarter of 2016, as required, and with no material impact on its consolidated results of operations, financial position or liquidity.

In April 2015, the FASB issued ASU No. 2015-03, "Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs." The ASU requires that debt issuance costs related to recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. Prior to this ASU, debt issuance costs were required to be presented as an asset. The ASU is effective for public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. In August 2015, the FASB expanded this amendment to include SEC staff views related to debt issuance costs associated with line-of-credit arrangements. The SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. This amendment is also effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. The Corporation adopted the standards during the first quarter of 2016, as required, and reclassified $792,000 and $810,000 of debt issuance costs from other assets and presented as a deduction from the debt liability as of March 31, 2016 and December 31, 2015, respectively. The adoption of the standards did not have a material impact on the Corporation's consolidated results of operations, financial position or liquidity.

In September 2015, the FASB issued ASU No. 2015-16, "Business Combinations (Topic 805)." The ASU intends to simplify the accounting for measurement adjustments to prior business combinations. The amendment requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The acquirer must record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The amendment also requires an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. This amendment is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. The amendments should be applied prospectively to adjustments to provisional amounts that occur after the effective date of this amendment with earlier application permitted for financial statements that have not been issued. The Corporation adopted the standard during the first quarter of 2016, as required, with no material impact on its results of operations, financial position or liquidity.

In January 2016, the FASB issued ASU No. 2016-01, “Financial Instruments (Subtopic 825-10).” The ASU amends certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. This amendment supersedes the guidance to classify equity securities with readily determinable fair values into different categories, requires equity securities to be measured at fair value with changes in the fair value recognized through net income, and simplifies the impairment assessment of equity investments without readily determinable fair values. The amendment requires public business entities that are required to disclose the fair value of financial instruments measured at amortized cost on the balance sheet to measure that fair value using the exit price notion. The amendment requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option. The amendment requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or in the accompanying notes to the financial statements. The amendment reduces diversity in current practice by clarifying that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available for sale securities in combination with the entity’s other deferred tax assets. This amendment is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Entities should apply the amendment by means of a cumulative-effect adjustment as of the beginning of the fiscal year of adoption, with the exception of the amendment related to equity securities without readily determinable fair values, which should be applied prospectively to equity investments that exist as of the date of adoption. The Corporation intends to adopt the accounting standard during the first quarter of 2018, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842).” The ASU intends to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities and disclosing key information about leasing arrangements. The ASU will require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessees’ obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The new lease guidance simplifies the accounting for sale and leaseback transactions primarily because lessees must recognize lease assets and lease liabilities. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. The ASU is effective for public companies for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The Corporation intends to adopt the accounting standard during the first quarter of 2019, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity.

In March 2016, the FASB issued ASU No. 2016-09, “Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.” ASU No. 2016-09 simplifies several aspects of the accounting for share-based payment transactions, including income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. The Corporation early adopted ASU No. 2016-09 on October 1, 2016 with an effective date of January 1, 2016, which resulted in a reclassification of $139,000 from additional paid-in capital to income tax expense, representing excess tax benefits previously recognized in additional paid-in capital during the nine months ended September 30, 2016. During the three months ended December 31, 2016, the Corporation recognized a benefit of $4,000 in income taxes for excess tax benefits that occurred in the current quarter.

Adoption of the standard impacted the Corporation's previously reported quarterly results as follows:

	For the Three Months Ended					
	September 30, 2016		June 30, 2016		March 31, 2016	
	As Reported	As Adjusted	As Reported	As Adjusted	As Reported	As Adjusted
	(Dollars in Thousands, Except Share Data)					
Income tax (benefit) expense	$(2,895)	$(3,020)	$1,628	$1,621	$2,362	$2,356
Net income	2,540	2,665	3,716	3,723	4,547	4,553
Effective tax rate	NM	NM	30.5 %	30.3 %	34.2 %	34.1 %
Earnings per common share:						
Basic	$0.29	$0.31	$0.43	$0.43	$0.52	$0.52
Diluted	0.29	0.31	0.43	0.43	0.52	0.52
Additional paid-in capital	77,544	77,419	77,127	77,120	76,851	76,845
Retained earnings	88,255	88,380	86,760	86,767	84,089	84,095
Return on average assets (annualized)	0.56 %	0.59 %	0.81 %	0.82 %	1.00 %	1.00 %
Return on average equity (annualized)	6.38 %	6.69 %	9.43 %	9.45 %	11.68 %	11.70 %

NM = Not meaningful

For the year ended December 31, 2016, the Corporation reclassified excess tax benefits from other financing activities to other operating activities and for the years ended December 31, 2016, 2015 and 2014, the Corporation classified taxes paid related to net share settlement of equity awards in financing activities in the consolidated statements of cash flows, respectively. The Corporation elected to account for forfeitures as they occur.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments- Credit Losses (Topic 326)." The ASU replaces the incurred loss impairment methodology for recognizing credit losses with a methodology that reflects all expected credit losses. The ASU also requires consideration of a broader range of information to inform credit loss estimates, including such factors as past events, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, and any other financial asset not excluded from the scope that have the contractual right to receive cash. Entities will apply the amendments in the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. The ASU is effective for public companies for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of the fiscal years beginning after December 15, 2018. The Corporation intends to adopt the accounting standard during the first quarter of 2020, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230). The ASU provides guidance on eight specific cash flow issues with the objective of reducing diversity in practice. The ASU is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The amendments in this update will be applied retrospectively to each prior period presented. The Corporation intends to adopt the accounting standard during the first quarter of 2018, as required, and is currently evaluating the impact on its results of operations, financial position and liquidity.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)," with an original effective date for annual reporting periods beginning after December 15, 2016. The ASU is a converged standard between the FASB and the IASB that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The primary objective of the ASU is revenue recognition that represents the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In August 2015, the FASB issued ASU No. 2015-14, which defers the effective date of ASU 2014-09 to annual and interim reporting periods in fiscal years beginning after December 15, 2017. Earlier application is permitted only as of annual and interim reporting periods in fiscal years beginning after December 15, 2016. In March 2016, the FASB issued ASU No. 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net."

The ASU intends to improve the operability and understandability of the implementation guidance of ASU 2014-09 on principal versus agent considerations. In April, May and December 2016, the FASB also issued ASU No. 2016-10, No. 2016-12 and No. 2016-20, respectively, related to Topic 606. The amendments do not change the core principals of the previously issued guidance, but instead further clarify and provide implementation guidance for certain aspects of the original ASU. The Corporation intends to adopt the accounting standards during the first quarter of 2018, as required. The Corporation has conducted its initial assessment and is currently evaluating contracts to assess and quantify accounting methodology changes resulting from the adoption of this standard. The FASB continues to release new accounting guidance related to the adoption of this standard, which could impact the Corporation's initial assessment and may change the conclusions reached as to the application of this new guidance.

Note 2 – Cash and Cash Equivalents

Cash and due from banks was approximately $14.6 million at December 31, 2016 and 2015. Required reserves in the form of either vault cash or deposits held at the FRB were $6.4 million and $3.9 million at December 31, 2016 and 2015, respectively. FRB balances were $40.9 million and $84.9 million at December 31, 2016 and 2015, respectively, and are included in short-term investments on the Consolidated Balance Sheets. Short-term investments, considered cash equivalents, were $62.9 million and $98.9 million at December 31, 2016 and 2015, respectively.

Note 3 – Securities

The amortized cost and fair value of securities available-for-sale and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income were as follows:

	As of December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available-for-sale:				
U.S. Government agency obligations - government-sponsored enterprises	$6,298	$ 7	$ (10)	$6,295
Municipal obligations	8,246	2	(92)	8,156
Asset-backed securities	1,116	—	(35)	1,081
Collateralized mortgage obligations - government issued	30,936	423	(146)	31,213
Collateralized mortgage obligations - government-sponsored enterprises	99,865	252	(969)	99,148
	$146,461	$ 684	$ (1,252)	$145,893

	As of December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available-for-sale:				
U.S. Government agency obligations - government-sponsored enterprises	$8,047	$ 2	$ (32)	$8,017
Municipal obligations	4,278	12	(7)	4,283
Asset-backed securities	1,327	—	(58)	1,269
Collateralized mortgage obligations - government issued	43,845	814	(116)	44,543
Collateralized mortgage obligations - government-sponsored enterprises	82,707	145	(416)	82,436
	$140,204	$ 973	$ (629)	$140,548

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The amortized cost and fair value of securities held-to-maturity and the corresponding amounts of gross unrealized gains and losses were as follows:

	As of December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Held-to-maturity:				
U.S. Government agency obligations - government-sponsored enterprises	$1,497	$ 2	$ (5)	$1,494
Municipal obligations	21,173	62	(78)	21,157
Collateralized mortgage obligations - government issued	9,148	17	(38)	9,127
Collateralized mortgage obligations - government-sponsored enterprises	6,794	6	(58)	6,742
	$38,612	$ 87	$ (179)	$38,520

	As of December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Held-to-maturity:				
U.S. Government agency obligations - government-sponsored enterprises	$1,495	$ 1	$ (11)	$1,485
Municipal obligations	16,038	332	(5)	16,365
Collateralized mortgage obligations - government issued	11,718	32	(41)	11,709
Collateralized mortgage obligations - government-sponsored enterprises	8,031	12	(44)	7,999
	$37,282	$ 377	$ (101)	$37,558

U.S. Government agency obligations - government-sponsored enterprises represent securities issued by the Federal Home Loan Mortgage Corporation (“FHLMC”) and Federal National Mortgage Association (“FNMA”). Municipal obligations include securities issued by various municipalities located primarily within the State of Wisconsin and are primarily general obligation bonds that are tax-exempt in nature. Asset-backed securities represent securities issued by the Student Loan Marketing Association (“SLMA”) which are 97% guaranteed by the U.S. Government. Collateralized mortgage obligations - government issued represent securities guaranteed by the Government National Mortgage Association (“GNMA”). Collateralized mortgage obligations - government-sponsored enterprises include securities guaranteed by the FHLMC and the FNMA. For the year ended December 31, 2016, a gain of $10,000 was recorded from the sale of five available-for-sale securities. No sales of available-for-sale securities occurred during the years ended December 31, 2015 and 2014.

At December 31, 2016 and 2015, securities with a fair value of $22.4 million and $23.0 million, respectively, were pledged to secure interest rate swap contracts, outstanding FHLB advances, if any, and additional FHLB availability.

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The amortized cost and fair value of securities by contractual maturity at December 31, 2016 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay certain obligations without call or prepayment penalties.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)			
Due in one year or less	$4,532	$4,532	$—	$—
Due in one year through five years	15,308	15,245	7,111	7,100
Due in five through ten years	66,396	66,710	13,994	13,978
Due in over ten years	60,225	59,406	17,507	17,442
	$146,461	$145,893	$38,612	$38,520

The tables below show the Corporation's gross unrealized losses and fair value of available-for-sale investments with unrealized losses aggregated by investment category and length of time that individual investments were in a continuous loss position at December 31, 2016 and 2015. At December 31, 2016, the Corporation held 108 available-for-sale securities that were in an unrealized loss position. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. At December 31, 2016, the Corporation held seven available-for-sale securities that had been in a continuous unrealized loss position for twelve months or greater.

The Corporation also has not specifically identified available-for-sale securities in a loss position that it intends to sell in the near term and does not believe that it will be required to sell any such securities. The Corporation reviews its securities on a quarterly basis to monitor its exposure to other-than-temporary impairment. Consideration is given to such factors as the length of time and extent to which the security has been in an unrealized loss position, changes in security ratings and an evaluation of the present value of expected future cash flows, if necessary. Based on the Corporation's evaluation, it is expected that the Corporation will recover the entire amortized cost basis of each security. Accordingly, no other than temporary impairment was recorded in the Consolidated Statements of Income for the years ended December 31, 2016 and 2015.

A summary of unrealized loss information for securities available-for-sale, categorized by security type and length of time for which the security has been in a continuous unrealized loss position, follows:

	December 31, 2016					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
Available-for-sale:						
U.S. Government agency obligations - government-sponsored enterprises	$1,991	$ 10	$—	$ —	$1,991	$ 10
Municipal obligations	7,207	89	406	3	7,613	92
Asset-backed securities	—	—	1,081	35	1,081	35
Collateralized mortgage obligations - government issued	10,552	130	493	16	11,045	146
Collateralized mortgage obligations - government-sponsored enterprises	54,843	931	1,819	38	56,662	969
	$74,593	$ 1,160	$3,799	$ 92	$78,392	$ 1,252

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	December 31, 2015					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
Available-for-sale:						
U.S. Government agency obligations - government-sponsored enterprises	$3,536	$ 13	$1,981	$ 19	$5,517	$ 32
Municipal obligations	2,403	7	—	—	2,403	7
Asset-backed securities	1,269	58	—	—	1,269	58
Collateralized mortgage obligations - government issued	3,373	19	5,687	97	9,060	116
Collateralized mortgage obligations - government-sponsored enterprises	59,992	373	1,717	43	61,709	416
	$70,573	$ 470	$9,385	$ 159	$79,958	$ 629

The tables below show the Corporation's gross unrealized losses and fair value of held-to-maturity investments, aggregated by investment category and length of time that individual investments were in a continuous loss position at December 31, 2016 and 2015. At December 31, 2016, the Corporation held 57 held-to-maturity securities that were in an unrecognized loss position. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. There were no held-to-maturity securities that had been in a continuous loss position for twelve months or greater as of December 31, 2016. It is expected that the Corporation will recover the entire amortized cost basis of each held-to-maturity security based upon an evaluation of the aforementioned factors. Accordingly, no other-than-temporary impairment was recorded in the Consolidated Statements of Income for the years ended December 31, 2016 and 2015.

A summary of unrealized loss information for securities held-to-maturity, categorized by security type and length of time for which the security has been in a continuous unrealized loss position, follows:

	December 31, 2016					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
Held-to-maturity:						
U.S. Government agency obligations - government-sponsored enterprises	$1,000	$ 5	$ —	$ —	$1,000	$ 5
Municipal obligations	9,472	78	—	—	9,472	78
Collateralized mortgage obligations - government issued	6,980	38	—	—	6,980	38
Collateralized mortgage obligations - government-sponsored enterprises	4,682	58	—	—	4,682	58
	$22,134	$ 179	$ —	$ —	$22,134	$ 179

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	December 31, 2015					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In Thousands)					
Held-to-maturity:						
U.S. Government agency obligations - government-sponsored enterprises	$—	$ —	$1,000	$ 11	$1,000	$ 11
Municipal obligations	436	4	199	1	635	5
Collateralized mortgage obligations - government issued	6,518	$ 41	—	—	6,518	41
Collateralized mortgage obligations - government-sponsored enterprises	5,168	44	—	—	5,168	44
	$12,122	$ 89	$1,199	$ 12	$13,321	$ 101

Note 4 – Loan and Lease Receivables, Impaired Loans and Leases and Allowance for Loan and Lease Losses

Loan and lease receivables consist of the following:

	December 31, 2016	December 31, 2015
	(In Thousands)	
Commercial real estate:		
Commercial real estate — owner occupied	$176,459	$ 176,322
Commercial real estate — non-owner occupied	473,158	436,901
Land development	56,638	59,779
Construction	101,206	100,625
Multi-family	92,762	80,254
1-4 family	45,651	50,304
Total commercial real estate	945,874	904,185
Commercial and industrial	450,298	472,193
Direct financing leases, net	30,951	31,093
Consumer and other:		
Home equity and second mortgages	8,412	8,237
Other	16,329	16,319
Total consumer and other	24,741	24,556
Total gross loans and leases receivable	1,451,864	1,432,027
Less:		
Allowance for loan and lease losses	20,912	16,316
Deferred loan fees	1,189	1,062
Loans and leases receivable, net	$1,429,763	$ 1,414,649

As of December 31, 2016 and 2015, the total amount of the Corporation’s ownership of SBA loans on the Consolidated Balance Sheets was $62.1 million and $53.2 million, respectively. As of December 31, 2016 and 2015, $5.5 million and $1.1 million of loans in this portfolio were considered impaired, respectively.

Loans transferred to third parties consist of the guaranteed portion of SBA loans which the Corporation sold in the secondary market, as well as participation interests in other originated loans. The total principal amount of the guaranteed portion of SBA loans sold during the year ended December 31, 2016 and 2015 was $41.2 million and $40.2 million, respectively. Each of the transfers of these financial assets met the qualifications for sale accounting, and therefore, all of the loans transferred during the

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year ended December 31, 2016 and 2015 have been derecognized in the Consolidated Financial Statements. The guaranteed portion of SBA loans were transferred at their fair value and the related gain was recognized upon the transfer as non-interest income in the Consolidated Financial Statements. The total outstanding balance of sold SBA loans at December 31, 2016 and 2015 was $105.1 million and $78.2 million, respectively, while the retained, unguaranteed portion of sold SBA loans on the Corporation's Consolidated Balance Sheets was $32.2 million and $26.2 million as of December 31, 2016 and 2015, respectively.

The total principal amount of transferred participation interests in other originated commercial loans during the year ended December 31, 2016 and 2015 was $17.6 million and $26.8 million, respectively, all of which were treated as sales and derecognized under the applicable accounting guidance at the time of transfer. No gain or loss was recognized on participation interests in other originated loans as they were transferred at or near the date of loan origination and the payments received for servicing the portion of the loans participated represents adequate compensation. The total outstanding balance of these transferred loans at December 31, 2016 and 2015 was $102.7 million and $91.0 million, respectively. As of December 31, 2016 and 2015, the total amount of the Corporation's partial ownership of these transferred loans on the Consolidated Balance Sheets was $106.1 million and $110.6 million, respectively. No loans in this participation portfolio were considered impaired as of December 31, 2016 and 2015. The Corporation does not share in the participant's portion of any potential charge-offs. The total amount of loan participations purchased on the Consolidated Balance Sheets as of December 31, 2016 and 2015 was $1.2 million and $1.8 million, respectively.

The Corporation also sells residential real estate loans, servicing released, in the secondary market. The total principal amount of residential real estate loans sold during the year ended December 31, 2016 and 2015 was $26.3 million and $32.6 million, respectively. Each of the transfers of these financial assets met the qualifications for sale accounting, and therefore all of the loans transferred have been derecognized in the Consolidated Financial Statements. The loans were transferred at their fair value and the related gain was recognized as non-interest income upon the transfer in the Consolidated Financial Statements.

According to ASC 310-30, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, purchased credit-impaired loans exhibit evidence of deterioration in credit quality since origination for which it is probable at acquisition that the Corporation will be unable to collect all contractually required payments. Purchased credit-impaired loans are initially recorded at fair value, which is estimated by discounting the cash flows expected to be collected at the acquisition date. Because the estimate of expected cash flows reflects an estimate of future credit losses expected to be incurred over the life of the loans, an allowance for credit losses is not recorded at the acquisition date. The excess of cash flows expected at acquisition over the estimated fair value, referred to as the accretable yield, is recognized in interest income over the remaining life of the loan on a level-yield basis, contingent on the subsequent evaluation of future expected cash flows. The difference between the contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference. A subsequent decrease in the estimate of cash flows expected to be received on purchased credit-impaired loans generally results in the recognition of an allowance for loan and lease losses. Subsequent increases in cash flows result in reversal of any nonaccretable difference (or allowance for loan and lease losses to the extent any has been recorded) with a positive impact on interest income recognized. The measurement of cash flows involves assumptions and judgments for interest rates, prepayments, default rates, loss severity and collateral values. All of these factors are inherently subjective and significant changes in the cash flow estimates over the life of the loan can result.

The following table reflects the contractually required payments receivable and fair value of the Corporation's purchased credit-impaired loans as of December 31, 2016 and 2015:

	December 31, 2016	December 31, 2015
	(In Thousands)	
Contractually required payments	$3,265	$ 5,291
Fair value of purchased credit-impaired loans	1,432	3,250

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The following table presents a rollforward of the accretable yield for the year ended December 31, 2016 and 2015:

	December 31, 2016	December 31, 2015
	(In Thousands)	
Accretable yield, beginning of period	$414	$ 676
Accretion recognized in interest income	(129)	(50)
Reclassification to nonaccretable difference for loans with changing cash flows[1]	(244)	(60)
Changes in accretable yield for non-credit related changes in expected cash flows[2]	94	(152)
Accretable yield, end of period	$135	$ 414

(1) Represents changes in accretable yield for those loans that are driven primarily by credit performance.

(2) Represents changes in accretable yield for those loans that are driven primarily by changes in actual and estimated payments.

Certain of the Corporation’s executive officers, directors and their related interests are loan clients of the Banks. As of December 31, 2016 and 2015, loans aggregating approximately $6.3 million and $6.9 million, respectively, were outstanding to such parties. New loans granted to such parties during the years ended December 31, 2016 and 2015 were approximately $673,000 and $3.9 million and repayments on such loans were approximately $1.3 million and $1.4 million, respectively. These loans were made in the ordinary course of business and on substantially the same terms as those prevailing at the time for comparable loans not related to the lender. None of these loans were considered impaired as of December 31, 2016 or 2015.

The following information illustrates ending balances of the Corporation’s loan and lease portfolio, including impaired loans by class of receivable, and considering certain credit quality indicators as of December 31, 2016 and 2015:

	December 31, 2016				
	Category				
	I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	$142,704	$20,294	$11,174	$2,287	$176,459
Commercial real estate — non-owner occupied	447,895	20,933	2,721	1,609	473,158
Land development	52,082	823	293	3,440	56,638
Construction	93,510	3,154	1,624	2,918	101,206
Multi-family	87,418	1,937	3,407	—	92,762
1-4 family	38,504	3,144	1,431	2,572	45,651
Total commercial real estate	862,113	50,285	20,650	12,826	945,874
Commercial and industrial	348,201	42,949	46,675	12,473	450,298
Direct financing leases, net	29,351	1,600	—	—	30,951
Consumer and other:					
Home equity and second mortgages	8,271	121	12	8	8,412
Other	15,714	—	11	604	16,329
Total consumer and other	23,985	121	23	612	24,741
Total gross loans and leases receivable	$1,263,650	$94,955	$67,348	$25,911	$1,451,864
Category as a % of total portfolio	87.04 %	6.54 %	4.64 %	1.78 %	100.00 %

	December 31, 2015				
	Category				
	I	II	III	IV	Total
	(Dollars in Thousands)				
Commercial real estate:					
Commercial real estate — owner occupied	$156,379	$7,654	$9,311	$2,978	$176,322
Commercial real estate — non-owner occupied	410,517	20,662	3,408	2,314	436,901
Land development	52,817	2,241	309	4,412	59,779
Construction	98,693	851	564	517	100,625
Multi-family	79,368	884	—	2	80,254
1-4 family	41,086	3,985	1,865	3,368	50,304
Total commercial real estate	838,860	36,277	15,457	13,591	904,185
Commercial and industrial	430,199	7,139	25,706	9,149	472,193
Direct financing leases, net	29,514	1,013	528	38	31,093
Consumer and other:					
Home equity and second mortgages	7,497	—	141	599	8,237
Other	15,616	48	—	655	16,319
Total consumer and other	23,113	48	141	1,254	24,556
Total gross loans and leases receivable	$1,321,686	$44,477	$41,832	$24,032	$1,432,027
Category as a % of total portfolio	92.29 %	3.11 %	2.92 %	1.68 %	100.00 %

Credit underwriting through a committee process is a key component of the Corporation's operating philosophy. Commercial lenders have relatively low individual lending authority limits, and thus a significant portion of the Corporation's new credit extensions require approval from a loan approval committee regardless of the type of loan or lease, asset quality grade of the credit, amount of the credit or the related complexities of each proposal.

Each credit is evaluated for proper risk rating upon origination, at the time of each subsequent renewal, upon receipt and evaluation of updated financial information from the Corporation's borrowers or as other circumstances dictate. The Corporation uses a nine grade risk rating system to monitor the ongoing credit quality of its loans and leases. The risk rating grades follow a consistent definition and are then applied to specific loan types based on the nature of the loan. Each risk rating is subjective and, depending on the size and nature of the credit, subject to various levels of review and concurrence on the stated risk rating. In addition to its nine grade risk rating system, the Corporation groups loans into four loan and related risk categories which determine the level and nature of review by management.

Category I — Loans and leases in this category are performing in accordance with the terms of the contract and generally exhibit no immediate concerns regarding the security and viability of the underlying collateral, financial stability of the borrower, integrity or strength of the borrower's management team or the industry in which the borrower operates. Loans and leases in this category are not subject to additional monitoring procedures above and beyond what is required at the origination or renewal of the loan or lease. The Corporation monitors Category I loans and leases through payment performance, continued maintenance of its personal relationships with such borrowers and continued review of such borrowers' compliance with the terms of their respective agreements.

Category II — Loans and leases in this category are beginning to show signs of deterioration in one or more of the Corporation's core underwriting criteria such as financial stability, management strength, industry trends or collateral values. Management will place credits in this category to allow for proactive monitoring and resolution with the borrower to possibly mitigate the area of concern and prevent further deterioration or risk of loss to the Corporation. Category II loans are considered performing but are monitored frequently by the assigned business development officer and by subcommittees of the Banks' loan committees.

Category III — Loans and leases in this category are identified by management as warranting special attention. However, the balance in this category is not intended to represent the amount of adversely classified assets held by the Banks. Category III loans and leases generally exhibit undesirable characteristics, such as evidence of adverse financial trends and conditions, managerial problems, deteriorating economic conditions within the related industry or evidence of adverse public filings and may exhibit collateral shortfall positions. Management continues to believe that it will collect all contractual principal and interest in accordance with the original terms of the contracts relating to the loans and leases in this category, and therefore Category III loans are considered performing with no specific reserves established for this category. Category III loans are monitored by management and the Banks' loan committees on a monthly basis and the Banks' boards of directors at each of their regularly scheduled meetings.

Category IV — Loans and leases in this category are considered to be impaired. Impaired loans and leases have been placed on non-accrual as management has determined that it is unlikely that the Banks will receive the contractual principal and interest in accordance with the original terms of the agreement. Impaired loans are individually evaluated to assess the need for the establishment of specific reserves or charge-offs. When analyzing the adequacy of collateral, the Corporation obtains external appraisals at least annually for impaired loans and leases. External appraisals are obtained from the Corporation's approved appraiser listing and are independently reviewed to monitor the quality of such appraisals. To the extent a collateral shortfall position is present, a specific reserve or charge-off will be recorded to reflect the magnitude of the impairment. Loans and leases in this category are monitored by management and the Banks' loan committees on a monthly basis and the Banks' boards of directors at each of their regularly scheduled meetings.

Utilizing regulatory classification terminology, the Corporation identified $34.3 million and $26.8 million of loans and leases as Substandard as of December 31, 2016 and 2015, respectively. No loans were considered Special Mention, Doubtful or Loss as of either December 31, 2016 or 2015. The population of Substandard loans is a subset of Category III and Category IV loans.

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The delinquency aging of the loan and lease portfolio by class of receivable as of December 31, 2016 and 2015 were as follows:

	December 31, 2016					
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current	Total
	(Dollars in Thousands)					
Accruing loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$—	$—	$174,236	$174,236
Non-owner occupied	—	—	—	—	471,549	471,549
Land development	—	—	—	—	53,198	53,198
Construction	—	—	—	—	98,288	98,288
Multi-family	—	—	—	—	92,762	92,762
1-4 family	75	—	—	75	43,639	43,714
Commercial and industrial	55	468	—	523	437,312	437,835
Direct financing leases, net	—	—	—	—	30,951	30,951
Consumer and other:						
Home equity and second mortgages	—	—	—	—	8,412	8,412
Other	—	—	—	—	15,725	15,725
Total	$130	$468	$—	$598	$1,426,072	$1,426,670
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$1,183	$1,183	$1,040	$2,223
Non-owner occupied	—	—	—	—	1,609	1,609
Land development	—	—	—	—	3,440	3,440
Construction	2,482	—	436	2,918	—	2,918
Multi-family	—	—	—	—	—	—
1-4 family	—	—	1,240	1,240	697	1,937
Commercial and industrial	3,345	168	6,740	10,253	2,210	12,463
Direct financing leases, net	—	—	—	—	—	—
Consumer and other:						
Home equity and second mortgages	—	—	—	—	—	—
Other	186	—	378	564	40	604
Total	$6,013	$168	$9,977	$16,158	$9,036	$25,194
Total loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$1,183	$1,183	$175,276	$176,459
Non-owner occupied	—	—	—	—	473,158	473,158
Land development	—	—	—	—	56,638	56,638
Construction	2,482	—	436	2,918	98,288	101,206
Multi-family	—	—	—	—	92,762	92,762
1-4 family	75	—	1,240	1,315	44,336	45,651
Commercial and industrial	3,400	636	6,740	10,776	439,522	450,298
Direct financing leases, net	—	—	—	—	30,951	30,951
Consumer and other:						
Home equity and second mortgages	—	—	—	—	8,412	8,412
Other	186	—	378	564	15,765	16,329

Total	$6,143	$636	$9,977	$16,756	$1,435,108	$1,451,864
Percent of portfolio	0.42 %	0.04 %	0.69 %	1.15 %	98.85 %	100.00 %

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	December 31, 2015					
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current	Total
	(Dollars in Thousands)					
Accruing loans and leases						
Commercial real estate:						
Owner occupied	$—	$—	$—	$—	$173,416	$173,416
Non-owner occupied	—	—	—	—	435,222	435,222
Land development	—	—	—	—	55,386	55,386
Construction	—	—	—	—	100,228	100,228
Multi-family	—	—	—	—	80,252	80,252
1-4 family	78	—	—	78	47,676	47,754
Commercial and industrial	—	—	—	—	463,057	463,057
Direct financing leases, net	—	—	—	—	31,055	31,055
Consumer and other:						
Home equity and second mortgages	—	—	—	—	7,695	7,695
Other	—	—	—	—	15,664	15,664
Total	$78	$—	$—	$78	$1,409,651	$1,409,729
Non-accruing loans and leases						
Commercial real estate:						
Owner occupied	$—	$473	$—	$473	$2,433	$2,906
Non-owner occupied	—	—	—	—	1,679	1,679
Land development	—	—	—	—	4,393	4,393
Construction	397	—	—	397	—	397
Multi-family	—	—	—	—	2	2
1-4 family	430	34	895	1,359	1,191	2,550
Commercial and industrial	2,077	—	564	2,641	6,495	9,136
Direct financing leases, net	—	—	—	—	38	38
Consumer and other:						
Home equity and second mortgages	—	—	250	250	292	542
Other	—	—	655	655	—	655
Total	$2,904	$507	$2,364	$5,775	$16,523	$22,298
Total loans and leases						
Commercial real estate:						
Owner occupied	$—	$473	$—	$473	$175,849	$176,322
Non-owner occupied	—	—	—	—	436,901	436,901
Land development	—	—	—	—	59,779	59,779
Construction	397	—	—	397	100,228	100,625
Multi-family	—	—	—	—	80,254	80,254
1-4 family	508	34	895	1,437	48,867	50,304
Commercial and industrial	2,077	—	564	2,641	469,552	472,193
Direct financing leases, net	—	—	—	—	31,093	31,093
Consumer and other:						
Home equity and second mortgages	—	—	250	250	7,987	8,237
Other	—	—	655	655	15,664	16,319
Total	$2,982	$507	$2,364	$5,853	$1,426,174	$1,432,027

Percent of portfolio	0.21 %	0.04 %	0.16 %	0.41 %	99.59 %	100.00 %

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The Corporation's total impaired assets consisted of the following at December 31, 2016 and 2015, respectively.

	December 31, 2016	December 31, 2015
	(In Thousands)	
Non-accrual loans and leases		
Commercial real estate:		
Commercial real estate — owner occupied	$2,223	$ 2,907
Commercial real estate — non-owner occupied	1,609	1,678
Land development	3,440	4,393
Construction	2,918	397
Multi-family	—	2
1-4 family	1,937	2,550
Total non-accrual commercial real estate	12,127	11,927
Commercial and industrial	12,463	9,136
Direct financing leases, net	—	38
Consumer and other:		
Home equity and second mortgages	—	542
Other	604	655
Total non-accrual consumer and other loans	604	1,197
Total non-accrual loans and leases	25,194	22,298
Foreclosed properties, net	1,472	1,677
Total non-performing assets	26,666	23,975
Performing troubled debt restructurings	717	1,735
Total impaired assets	$27,383	$ 25,710

	December 31, 2016		December 31, 2015	
Total non-accrual loans and leases to gross loans and leases	1.74	%	1.56	%
Total non-performing assets to total gross loans and leases plus foreclosed properties, net	1.83		1.67	
Total non-performing assets to total assets	1.50		1.35	
Allowance for loan and lease losses to gross loans and leases	1.44		1.14	
Allowance for loan and lease losses to non-accrual loans and leases	83.00		73.17	

As of December 31, 2016 and 2015, $12.8 million and $16.2 million of the non-accrual loans and leases were considered troubled debt restructurings, respectively. There were no unfunded commitments associated with troubled debt restructured loans and leases as of December 31, 2016.

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The following table provides the number of loans modified in a troubled debt restructuring and the pre- and post-modification recorded investment by class of receivable as of December 31, 2016 and 2015:

	As of December 31, 2016			As of December 31, 2015		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
	(Dollars in Thousands)					
Commercial real estate:						
Commercial real estate — owner occupied	3	$ 1,065	$ 930	3	$ 1,209	$ 1,188
Commercial real estate — non-owner occupied	1	158	39	5	1,150	904
Land development	1	5,745	3,440	2	5,853	4,393
Construction	2	331	314	1	181	200
Multi-family	—	—	—	1	184	2
1-4 family	11	1,391	1,393	15	2,035	1,869
Commercial and industrial	10	8,094	7,058	10	7,572	8,330
Consumer and other:						
Home equity and second mortgage	1	37	8	4	461	349
Other	1	2,076	378	1	2,076	655
Total	30	$ 18,897	$ 13,560	42	$ 20,721	$ 17,890

All loans and leases modified as a troubled debt restructuring are evaluated for impairment. The nature and extent of the impairment of restructured loans, including those which have experienced a default, is considered in the determination of an appropriate level of the allowance for loan and lease losses.

As of December 31, 2016 and 2015, the Corporation's troubled debt restructurings grouped by type of concession were as follows:

	As of December 31, 2016		As of December 31, 2015	
	Number of Loans	Post-Modification Recorded Investment	Number of Loans	Post-Modification Recorded Investment
	(Dollars in Thousands)			
Commercial real estate:				
Extension of term	1	$ 8	1	$ 24
Interest rate concession	1	52	1	55
Combination of extension of term and interest rate concession	16	6,056	25	8,477
Commercial and industrial:				
Combination of extension of term and interest rate concession	10	7,058	10	8,330
Consumer and other:				
Extension of term	1	378	1	655
Combination of extension of term and interest rate concession	1	8	4	349
Total	30	$ 13,560	42	$ 17,890

There were no loans and leases modified in a troubled debt restructuring during the previous 12 months which subsequently defaulted during the year ended December 31, 2016.

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The following represents additional information regarding the Corporation's impaired loans and leases, including performing troubled debt restructurings, by class:

	As of and for the Year Ended December 31, 2016						
	Recorded Investment	Unpaid Principal Balance	Impairment Reserve	Average Recorded Investment[(1)]	Foregone Interest Income	Interest Income Recognized	Net Foregone Interest Income
	(In Thousands)						
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$1,788	$1,788	$ —	$ 3,577	$ 328	$ 118	$ 210
Non-owner occupied	1,609	1,647	—	1,318	91	79	12
Land development	3,440	6,111	—	3,898	107	—	107
Construction	436	438	—	291	20	—	20
Multi-family	—	—	—	—	1	134	(133)
1-4 family	2,379	2,379	—	2,755	125	94	31
Commercial and industrial	3,769	3,769	—	918	143	62	81
Direct financing leases, net	—	—	—	6	—	—	—
Consumer and other:							
Home equity and second mortgages	8	8	—	307	16	127	(111)
Other	604	1,270	—	529	71	—	71
Total	$14,033	$17,410	$ —	$ 13,599	$ 902	$ 614	$ 288
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$499	$499	$ 70	$ 111	$ 28	$ —	$ 28
Non-owner occupied	—	—	—	—	—	—	—
Land development	—	—	—	—	—	—	—
Construction	2,482	2,482	1,790	834	45	—	45
Multi-family	—	—	—	—	—	—	—
1-4 family	193	199	39	203	5	—	5
Commercial and industrial	8,704	8,704	3,700	8,239	637	—	637
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Total	$11,878	$11,884	$ 5,599	$ 9,387	$ 715	$ —	$ 715
Total:							
Commercial real estate:							
Owner occupied	$2,287	$2,287	$ 70	$ 3,688	$ 356	$ 118	$ 238
Non-owner occupied	1,609	1,647	—	1,318	91	79	12
Land development	3,440	6,111	—	3,898	107	—	107
Construction	2,918	2,920	1,790	1,125	65	—	65
Multi-family	—	—	—	—	1	134	(133)
1-4 family	2,572	2,578	39	2,958	130	94	36
Commercial and industrial	12,473	12,473	3,700	9,157	780	62	718
Direct financing leases, net	—	—	—	6	—	—	—
Consumer and other:							
Home equity and second mortgages	8	8	—	307	16	127	(111)
Other	604	1,270	—	529	71	—	71

Grand total	$25,911	$29,294	$ 5,599	$ 22,986	$ 1,617	$ 614	$ 1,003

(1) Average recorded investment is calculated primarily using daily average balances.

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	As of and for the Year Ended December 31, 2015						
	Recorded Investment	Unpaid Principal Balance	Impairment Reserve	Average Recorded Investment(1)	Foregone Interest Income	Interest Income Recognized	Net Foregone Interest Income
	(In Thousands)						
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$2,164	$2,164	$ —	$ 712	$ 53	$ 12	$ 41
Non-owner occupied	2,314	2,355	—	962	25	—	25
Land development	4,413	7,083	—	4,333	133	—	133
Construction	120	120	—	474	—	—	—
Multi-family	2	369	—	10	27	—	27
1-4 family	2,423	2,486	—	1,604	82	4	78
Commercial and industrial	2,546	2,590	—	544	172	6	166
Direct financing leases, net	38	38	—	4	—	—	—
Consumer and other:							
Home equity and second mortgages	500	500	—	390	23	63	(40)
Other	655	1,321	—	688	82	—	82
Total	$15,175	$19,026	$ —	$ 9,721	$ 597	$ 85	$ 512
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$814	$814	$ 20	$ 215	$ 7	$ 2	$ 5
Non-owner occupied	—	—	—	—	—	—	—
Land development	—	—	—	—	—	—	—
Construction	397	397	48	34	—	—	—
Multi-family	—	—	—	—	—	—	—
1-4 family	945	950	173	605	34	—	34
Commercial and industrial	6,603	6,603	847	810	102	—	102
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	99	99	25	58	10	—	10
Other	—	—	—	—	—	—	—
Total	$8,858	$8,863	$ 1,113	$ 1,722	$ 153	$ 2	$ 151
Total:							
Commercial real estate:							
Owner occupied	$2,978	$2,978	$ 20	$ 927	$ 60	$ 14	$ 46
Non-owner occupied	2,314	2,355	—	962	25	—	25
Land development	4,413	7,083	—	4,333	133	—	133
Construction	517	517	48	508	—	—	—
Multi-family	2	369	—	10	27	—	27
1-4 family	3,368	3,436	173	2,209	116	4	112
Commercial and industrial	9,149	9,193	847	1,354	274	6	268
Direct financing leases, net	38	38	—	4	—	—	—
Consumer and other:							
Home equity and second mortgages	599	599	25	448	33	63	(30)
Other	655	1,321	—	688	82	—	82
Grand total	$24,033	$27,889	$ 1,113	$ 11,443	$ 750	$ 87	$ 663

(1) Average recorded investment is calculated primarily using daily average balances.

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	As of and for the Year Ended December 31, 2014						
	Recorded Investment	Unpaid Principal Balance	Impairment Reserve	Average Recorded Investment(1)	Foregone Interest Income	Interest Income Recognized	Net Foregone Interest Income
	(In Thousands)						
With no impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$577	$577	$ —	$ 484	$ 30	$ 79	$ (49)
Non-owner occupied	921	921	—	349	22	—	22
Land development	4,962	7,633	—	5,253	155	—	155
Construction	195	195	—	32	—	—	—
Multi-family	17	384	—	24	53	—	53
1-4 family	1,181	1,218	—	380	15	12	3
Commercial and industrial	2,316	2,926	—	6,141	463	649	(186)
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	380	380	—	495	18	—	18
Other	721	1,389	—	768	87	—	87
Total	$11,270	$15,623	$ —	$ 13,926	$ 843	$ 740	$ 103
With impairment reserve recorded:							
Commercial real estate:							
Owner occupied	$—	$—	$ —	$ —	$ —	$ —	$ —
Non-owner occupied	49	89	49	52	4	—	4
Land development	—	—	—	—	—	—	—
Construction	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
1-4 family	390	390	155	405	18	—	18
Commercial and industrial	33	33	33	34	—	—	—
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	53	53	53	57	5	—	5
Other	—	—	—	—	—	—	—
Total	$525	$565	$ 290	$ 548	$ 27	$ —	$ 27
Total:							
Commercial real estate:							
Owner occupied	$577	$577	$ —	$ 484	$ 30	$ 79	$ (49)
Non-owner occupied	970	1,010	49	401	26	—	26
Land development	4,962	7,633	—	5,253	155	—	155
Construction	195	195	—	32	—	—	—
Multi-family	17	384	—	24	53	—	53
1-4 family	1,571	1,608	155	785	33	12	21
Commercial and industrial	2,349	2,959	33	6,175	463	649	(186)
Direct financing leases, net	—	—	—	—	—	—	—
Consumer and other:							
Home equity and second mortgages	433	433	53	552	23	—	23
Other	721	1,389	—	768	87	—	87
Grand total	$11,795	$16,188	$ 290	$ 14,474	$ 870	$ 740	$ 130

(1) Average recorded investment is calculated primarily using daily average balances.

The difference between the loans and leases recorded investment and the unpaid principal balance of $3.4 million, $3.9 million and $4.4 million as of December 31, 2016, 2015 and 2014, respectively, represents partial charge-offs resulting from losses due to the appraised value of the collateral securing the loans and leases being below the carrying values of the loans and leases. Impaired loans and leases also included $717,000, $1.7 million and $2.0 million of loans as of December 31, 2016, 2015 and 2014, respectively, that were performing troubled debt restructurings, and thus, although not on non-accrual, were reported as

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impaired due to the concession in terms. When a loan is placed on non-accrual, interest accrual is discontinued and previously accrued but uncollected interest is deducted from interest income. Cash payments collected on non-accrual loans are first applied to such loan’s principal. Foregone interest represents the interest that was contractually due on the loan but not received or recorded. To the extent the amount of principal on a non-accrual loan is fully collected and additional cash is received, the Corporation will recognize interest income.

To determine the level and composition of the allowance for loan and lease losses, the Corporation categorizes the portfolio into segments with similar risk characteristics. First, the Corporation evaluates loans and leases for potential impairment classification. The Corporation analyzes each loan and lease determined to be impaired on an individual basis to determine a specific reserve based upon the estimated value of the underlying collateral for collateral-dependent loans, or alternatively, the present value of expected cash flows. The Corporation applies historical trends from established risk factors to each category of loans and leases that has not been individually evaluated for the purpose of establishing the general portion of the allowance.

A summary of the activity in the allowance for loan and lease losses by portfolio segment is as follows:

	As of and for the Year Ended December 31, 2016			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(Dollars in Thousands)			
Allowance for loan and lease losses:				
Beginning balance	$11,220	$4,387	$709	$16,316
Charge-offs	(1,194)	(2,273)	(127)	(3,594)
Recoveries	274	91	7	372
Provision	2,084	5,765	(31)	7,818
Ending balance	$12,384	$7,970	$558	$20,912
Ending balance: individually evaluated for impairment	$1,899	$3,700	$—	$5,599
Ending balance: collectively evaluated for impairment	$10,485	$4,270	$558	$15,313
Ending balance: loans acquired with deteriorated credit quality	$—	$—	$—	$—
Loans and lease receivables:				
Ending balance, gross	$945,874	$481,249	$24,741	$1,451,864
Ending balance: individually evaluated for impairment	$11,222	$12,452	$612	$24,286
Ending balance: collectively evaluated for impairment	$933,048	$468,776	$24,129	$1,425,953
Ending balance: loans acquired with deteriorated credit quality	$1,604	$21	$—	$1,625
Allowance as percent of gross loans and leases	1.31 %	1.66 %	2.26 %	1.44 %

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	As of and for the Year Ended December 31, 2015			
	Commercial Real Estate	Commercial and Industrial	Consumer and Other	Total
	(Dollars in Thousands)			
Allowance for loan and lease losses:				
Beginning balance	$8,619	$5,492	$218	$14,329
Charge-offs	(793)	(711)	(9)	(1,513)
Recoveries	104	6	4	114
Provision	3,290	(400)	496	3,386
Ending balance	$11,220	$4,387	$709	$16,316
Ending balance: individually evaluated for impairment	$240	$847	$26	$1,113
Ending balance: collectively evaluated for impairment	$10,980	$3,540	$683	$15,203
Ending balance: loans acquired with deteriorated credit quality	$—	$—	$—	$—
Loans and lease receivables:				
Ending balance, gross	$904,185	$503,286	$24,556	$1,432,027
Ending balance: individually evaluated for impairment	$10,849	$8,942	$1,061	$20,852
Ending balance: collectively evaluated for impairment	$890,594	$494,098	$23,495	$1,408,187
Ending balance: loans acquired with deteriorated credit quality	$2,742	$246	$193	$3,181
Allowance as percent of gross loans and leases	1.24 %	0.87 %	2.89 %	1.14 %

The Corporation's net investment in direct financing leases consists of the following:

	As of December 31,	
	2016	2015
	(In Thousands)	
Minimum lease payments receivable	$26,096	$27,361
Estimated unguaranteed residual values in leased property	7,625	7,036
Initial direct costs	106	158
Unearned lease and residual income	(2,876)	(3,462)
Investment in commercial direct financing leases	$30,951	$31,093

There were no impairments of residual value of leased property during the years ended December 31, 2016, 2015 and 2014.

The Corporation leases equipment under direct financing leases expiring in future years. Some of these leases provide for additional rents based on use in excess of a stipulated minimum number of hours and generally allow the lessees to purchase the equipment for fair value at the end of the lease term.

Future aggregate maturities of minimum lease payments to be received are as follows:

	(In Thousands)
Maturities during year ended December 31,	
2017	$7,863
2018	7,584
2019	5,331
2020	3,520
2021	1,251
Thereafter	547
	$26,096

Note 5 – Premises and Equipment

A summary of premises and equipment at December 31, 2016 and 2015 is as follows:

	As of December 31,	
	2016	2015
	(In Thousands)	
Land	$650	$650
Building and leasehold improvements	3,019	2,879
Furniture and equipment	5,366	4,921
	9,035	8,450
Less: accumulated depreciation	(5,263)	(4,496)
Total premises and equipment, net	$3,772	$3,954

Depreciation expense was $767,000, $746,000 and $385,000 for the years ended December 31, 2016, 2015 and 2014, respectively.

Note 6 – Goodwill and Other Intangible Assets

Goodwill is not amortized, but is subject to impairment tests on at least an annual basis and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount (including goodwill). At December 31, 2016 and 2015, the Corporation had goodwill of $10.7 million, which was entirely related to the acquisition of Alterra in 2014.

The Corporation conducted its annual impairment test on July 1, 2016, utilizing a qualitative assessment, and concluded that it was more likely than not that Alterra's estimated fair value exceeded its carrying value. Due to continued credit deterioration at Alterra and management's decision to temporarily slow SBA production while investments to enhance the platform are made, management elected to again assess goodwill on November 30, 2016 by comparing the fair value of Alterra to its carrying value. The fair value of the reporting unit was determined based on a weighted average of the income and market approaches. The income approach establishes fair value based on estimated future cash flows of the reporting unit, discounted by an estimated weighted-average cost of capital developed using the capital asset pricing model, which reflects the overall level of inherent risk of the reporting unit. The income approach uses our projections of financial performance for a four-year period and includes assumptions about future revenue growth rates, operating margins and terminal values. The market approach establishes fair value by applying cash flow multiples to the respective reporting unit's operating performance. The multiples are derived from other publicly traded companies that are similar but not identical from an operational and economic standpoint. Based on this assessment, there was no evidence of goodwill impairment as of November 30, 2016. Management also assessed external and internal qualitative factors through December 31, 2016 and determined no changes to factors occurred that would negatively impact the goodwill test.

The Corporation has intangible assets that are amortized consisting of loan servicing rights and core deposit intangibles.

Loan servicing rights are recognized upon sale of the guaranteed portion of SBA loans with servicing rights retained. When SBA loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sales of loans. Loan servicing assets are subsequently measured using the amortization method, which requires servicing rights to be amortized into interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans. For the year ended December 31, 2016, 2015 and 2014, loan servicing asset amortization totaled $639,000, $197,000 and $24,000, respectively.

The estimated fair value of the Corporation's loan servicing asset was $1.9 million and $1.6 million as of December 31, 2016 and 2015, respectively. The Corporation periodically reviews this portfolio for impairment and engages a third-party valuation firm to assess the fair value of the overall servicing rights portfolio.

The core deposit intangible has a finite life and is amortized by the straight-line method over a period of seven years. Changes in the gross carrying amount, accumulated amortization and net book value of core deposit intangibles were as follows:

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	Year Ended December 31,		
	2016	2015	2014
	(In Thousands)		
Gross carrying amount	$347	$347	$347
Less: accumulated amortization	145	83	12
Net book value	$202	$264	$335
Amortization during the period	$62	$71	$12

Estimated amortization expense of core deposit intangibles for fiscal years 2017 through 2021 are as follows:

(In Thousands)	
Estimate for the year ended December 31,	
2017	$54
2018	47
2019	40
2020	35
2021	26
	$202

Note 7 – Other Assets

The Corporation is a limited partner in several limited partnership investments. The Corporation is not the general partner, does not have controlling ownership and is not the primary beneficiary in any of these limited partnerships and thus, the limited partnerships have not been consolidated. These investments are accounted for using the equity method of accounting and are evaluated for impairment at the end of each reporting period. For historic rehabilitation tax credits, the Corporation begins to evaluate its investments for impairment at the time the credit is earned, which is typically in the year the project is placed in service, through the end of its compliance period. New market tax credits are also evaluated for impairment beginning at the time the tax credits are earned on the project through the seven year compliance period.

Historic Rehabilitation Tax Credits

In 2015, the Corporation invested in a development entity through BOC Investment, LLC ("BOC"), a wholly-owned subsidiary of FBB, to acquire, rehabilitate and operate a historic building in Madison, Wisconsin. At December 31, 2016 and 2015, the net carrying value of the investment was $174,000 and $578,000, respectively. The Corporation contributed an additional $2.8 million to the project in 2016. During 2016, the Corporation recognized $3.8 million in historic tax credits related to this investment and $3.3 million in impairment of the underlying investment.

In 2016, the Corporation also invested in a development entity through Mitchell Street Apartments Investment, LLC ("Mitchell Street"), a wholly-owned subsidiary of FBB, to rehabilitate a historic building in Milwaukee, Wisconsin. At December 31, 2016, the net carrying value of the investment was $563,000. The aggregate capital contributions to the project will depend upon the final amount of the certified project costs, but are expected to approximate $5.5 million. The Corporation is also anticipating the sale of a portion of the state credits associated with the investment to a third party. No historic tax credits were received during the year ended December 31, 2016. The credits are expected to be taken in the fourth quarter of 2017 when the project is placed in service and are subject to a five year recapture period.

New Market Tax Credits

The Corporation invested in a community development entity ("CDE") through Rimrock Road Investment Fund LLC ("Rimrock"), a wholly-owned subsidiary of FBB, to develop and operate a real estate project located in a low-income community. At December 31, 2016 and 2015, Rimrock had one CDE investment with a net carrying value of $7.1 million and $7.5 million respectively. The investment provides federal new market tax credits over a seven year credit allowance period through 2020. The remaining federal new market tax credit to be utilized over a maximum of seven years was $1.8 million as of December 31, 2016. The Corporation's usage of the federal new market tax credit was approximately $375,000 during the years ended December 31, 2016 and 2015.

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Other Investments

The Corporation had an equity investment in Aldine Capital Fund, LP, a mezzanine fund, of $883,000 and $1.0 million as of December 31, 2016 and 2015, respectively. The Corporation's equity investment in Aldine Capital Fund II, LP, also a mezzanine fund, totaled $3.1 million and $2.2 million as of December 31, 2016 and 2015, respectively. The Corporation's share of these partnerships' income included in the Consolidated Statements of Income for the years ended December 31, 2016 and 2015 was $790,000 and $481,000, respectively.

The Corporation is the sole owner of $315,000 of common securities issued by FBFS Statutory Trust II ("Trust II"), a Delaware business trust. The purpose of Trust II was to complete the sale of $10.0 million of 10.50% fixed rate preferred securities. Trust II, a wholly owned subsidiary of the Corporation, was not consolidated into the financial statements of the Corporation. The investment in Trust II of $315,000 as of December 31, 2016 and 2015 is included in accrued interest receivable and other assets.

A summary of accrued interest receivable and other assets as of December 31, 2016 and 2015 was as follows:

	December 31, 2016	December 31, 2015
	(In Thousands)	
Accrued interest receivable	$4,677	$ 4,412
Net deferred tax asset	4,052	2,633
Investment in limited partnerships	3,963	3,215
Investment in a CDE	7,106	7,500
Investment in historic development entities	737	578
Investment in Trust II	315	315
Fair value of interest rate swaps	352	552
Prepaid expenses	3,074	3,330
Other assets	4,331	1,536
Total accrued interest receivable and other assets	$28,607	$ 24,071

Note 8 – Deposits

The composition of deposits at December 31, 2016 and 2015 is as follows:

	December 31, 2016			December 31, 2015		
	Balance	Average Balance	Average Rate	Balance	Average Balance	Average Rate
	(Dollars in Thousands)					
Non-interest-bearing transaction accounts	$252,638	$246,182	— %	$231,199	$211,945	— %
Interest-bearing transaction accounts	183,992	169,571	0.27	165,921	125,558	0.24
Money market accounts	627,090	642,784	0.48	612,642	602,842	0.55
Certificates of deposit	58,454	65,608	0.90	79,986	106,177	0.78
Wholesale deposits	416,681	467,826	1.62	487,483	450,460	1.43
Total deposits	$1,538,855	$1,591,971	0.74	$1,577,231	$1,496,982	0.73

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A summary of annual maturities of certificates of deposit outstanding and wholesale deposits at December 31, 2016 is as follows:

(In Thousands)	
Maturities during the year ended December 31,	
2017	$145,615
2018	123,135
2019	68,089
2020	85,173
2021	21,476
Thereafter	31,647
	$475,135

Deposits include approximately $8.9 million and $11.5 million of certificates of deposit and wholesale deposits which are denominated in amounts of $250,000 or more at December 31, 2016 and 2015, respectively.

Note 9 – FHLB Advances, Other Borrowings and Junior Subordinated Notes

The composition of borrowed funds at December 31, 2016 and 2015 was as follows. Weighted average balances represent year-to-date averages.

	December 31, 2016			December 31, 2015		
	Balance	Weighted Average Balance	Weighted Average Rate	Balance	Weighted Average Balance	Weighted Average Rate
	(Dollars in Thousands)					
Federal funds purchased	$—	$ 178	0.92 %	$—	$ 237	0.86 %
FHLB advances	33,578	14,485	0.97	8,198	14,779	0.75
Other borrowings	2,590	1,739	7.64	1,592	678	9.66
Line of credit	1,010	2,079	3.26	2,510	1,619	3.18
Subordinated notes payable	22,498	22,467	7.13	22,440	22,410	7.14
Junior subordinated notes	10,004	9,997	11.07	9,990	9,982	11.14
	$69,680	$ 50,945	6.03	$44,730	$ 49,705	5.94
Short-term borrowings	$20,588			$7,010		
Long-term borrowings	49,092			37,720		
	$69,680			$44,730		

The Corporation's subsidiary banks, FBB and FBB-Milwaukee, are members of the FHLB of Chicago while Alterra is a member of the FHLB of Topeka. Accordingly, all three subsidiary banks of the Corporation are permitted to obtain advances.

The Corporation has a $347.1 million FHLB line of credit available for advances and open line borrowings which is collateralized by mortgage-related securities, unencumbered first mortgage loans and secured small business loans as noted below. At December 31, 2016, $313.6 million of this line remained unused. There were no advances outstanding on the Corporation's open line at December 31, 2016 and 2015. There were $33.6 million of term FHLB advances outstanding at December 31, 2016 with stated fixed interest rates ranging from 0.83% to 4.43% compared to $8.2 million of term FHLB advances outstanding at December 31, 2015 with stated fixed interest rate ranging from 0.89% to 4.96%. The term FHLB advances outstanding at December 31, 2016 are due at various dates through August 2019.

The Corporation is required to maintain as collateral, mortgage-related securities and unencumbered first mortgage loans and secured small business loans in its portfolio aggregating at least the amount of outstanding advances from the FHLB. Loans totaling approximately $326.4 million and $75.0 million and collateralized mortgage obligations totaling approximately $20.7 million and $21.7 million were pledged as collateral for FHLB advances at

December 31, 2016 and 2015, respectively.
The Corporation has a senior line of credit with a third-party financial institution of $10.5 million. As of December 31, 2016, the line of credit carried an interest rate of LIBOR + 2.75% with an interest rate floor of 3.125% that matures on February 19, 2017 and had certain performance debt covenants of which the Corporation was in compliance. The Corporation pays a

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commitment fee on this senior line of credit. For the years ended December 31, 2016 and 2015 the Corporation incurred $13,000 additional interest expense due to this fee. On February 19, 2017, the credit line was renewed for one additional year with pricing terms of LIBOR + 2.75% with an interest rate floor of 3.125% and a maturity date of February 19, 2018. As of December 31, 2016, the outstanding balance on the line of credit was $1.0 million.

The Corporation has subordinated notes payable. At December 31, 2016, the amount of subordinated notes payable outstanding was $22.5 million, which qualified for Tier 2 capital. At December 31, 2016, $1.7 million of the subordinated notes bore an interest rate of LIBOR + 4.75% with an interest rate floor of 6.00% and a maturity date of May 15, 2021, $6.2 million bore a fixed interest rate of 7.50% and a maturity date of January 15, 2022 and $15.0 million bore a fixed interest rate of 6.50% with a maturity date of September 21, 2024. There are no debt covenants on the subordinated notes payable. The Corporation may, at its option, redeem the notes, in whole or part, at any time after the fifth anniversary of issuance. As of December 31, 2016, $428,000 of debt issuance costs remain in the subordinated notes payable balance.

In September 2008, Trust II completed the sale of $10.0 million of 10.50% fixed rate trust preferred securities (“Preferred Securities”). Trust II also issued common securities of $315,000. Trust II used the proceeds from the offering to purchase $10.3 million of 10.50% junior subordinated notes (“Notes”) of the Corporation. The Preferred Securities are mandatorily redeemable upon the maturity of the Notes on September 26, 2038. The Preferred Securities qualify under the risk-based capital guidelines as Tier 1 capital for regulatory purposes. Per the provisions of the Dodd-Frank Act, bank holding companies with total assets of less than $15 billion are not required to phase out trust preferred securities as an element of Tier 1 capital as other, larger institutions must. The Corporation used the proceeds from the sale of the Notes for general corporate purposes including providing additional capital to its subsidiaries. As of December 31, 2016, $311,000 of debt issuance costs remain reflected in junior subordinated notes on the Consolidated Balance Sheets.

The Corporation has the right to redeem the Notes at each interest payment date on or after September 26, 2013. The Corporation also has the right to redeem the Notes, in whole but not in part, after the occurrence of certain special events. Special events are limited to: (1) a change in capital treatment resulting in the inability of the Corporation to include the Notes in Tier 1 capital, (2) a change in laws or regulations that could require Trust II to register as an investment company under the Investment Company Act of 1940, as amended; and (3) a change in laws or regulations that would require Trust II to pay income tax with respect to interest received on the Notes or, prohibit the Corporation from deducting the interest payable by the Corporation on the Notes or result in greater than a de minimis amount of taxes for Trust II.

Note 10 – Regulatory Capital

The Corporation and the Banks are subject to various regulatory capital requirements administered by Federal, State of Wisconsin and State of Kansas banking agencies. Failure to meet minimum capital requirements can result in certain mandatory, and possibly additional discretionary actions on the part of regulators, that if undertaken, could have a direct material effect on the Banks’ assets, liabilities and certain off-balance-sheet items as calculated under regulatory practices. The Corporation’s and the Banks’ capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. The Corporation regularly reviews and updates when appropriate its Capital and Liquidity Action Plan (the “Capital Plan”), which is designed to help ensure appropriate capital adequacy, to plan for future capital needs and to ensure that the Corporation serves as a source of financial strength to the Banks. The Corporation’s and the Banks’ Boards of Directors and management teams adhere to the appropriate regulatory guidelines on decisions which affect their respective capital positions, including but not limited to, decisions relating to the payment of dividends and increasing indebtedness.

As a bank holding company, the Corporation’s ability to pay dividends is affected by the policies and enforcement powers of the Board of Governors of the Federal Reserve system (the “Federal Reserve”). Federal Reserve guidance urges companies to strongly consider eliminating, deferring or significantly reducing dividends if: (i) net income available to common shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividend; (ii) the prospective rate of earnings retention is not consistent with the bank holding company’s capital needs and overall current prospective financial condition; or (iii) the bank holding company will not meet, or is in danger of not meeting, its minimum regulatory capital ratios. Management intends, when appropriate under regulatory guidelines, to consult with the Federal Reserve Bank of Chicago and provide it with information on the Corporation's then-current and prospective earnings and capital position in advance of declaring any cash dividends. As a Wisconsin corporation, the Corporation is subject to the limitations of the Wisconsin Business Corporation Law, which prohibit the Corporation from paying dividends if such payment would: (i) render the Corporation unable to pay its debts as they become due in the usual course of business, or (ii) result in the Corporation's assets being less than the sum of its total liabilities plus the amount needed to satisfy the preferential rights upon dissolution of any stockholders with preferential rights superior to those stockholders receiving the dividend.

The Banks are also subject to certain legal, regulatory and other restrictions on their ability to pay dividends to the Corporation. As a bank holding company, the payment of dividends by the Banks to the Corporation is one of the sources of funds the Corporation could use to pay dividends, if any, in the future and to make other payments. Future dividend decisions by the Banks and the Corporation will continue to be subject to compliance with various legal, regulatory and other restrictions as defined from time to time.

Qualitative measures established by regulation to ensure capital adequacy require the Corporation and the Banks to maintain minimum amounts and ratios of Total Common Equity Tier 1 and Tier 1 capital to risk-weighted assets and of Tier 1 capital to adjusted total assets. These risk-based capital requirements presently address credit risk related to both recorded and off-balance-sheet commitments and obligations. Management believes, as of December 31, 2016, that the Corporation and the Banks met all applicable capital adequacy requirements.

In July 2013, the FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision’s (“BCBS”) capital guidelines for U.S. banks. These rules are applicable to all financial institutions that are subject to minimum capital requirements, including federal and state banks and savings and loan associations, as well as bank and savings and loan holding companies other than “small bank holding companies” (generally non-publicly traded bank holding companies with consolidated assets of less than $1 billion). Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Corporation. The rules include a new Common Equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. The rules also permit banking organizations with less than $15 billion to retain, through one-time election, the existing treatment for accumulated other comprehensive income, which would not affect regulatory capital. The Corporation elected to retain this treatment, which reduces the volatility of regulatory capital ratios. A new capital conservation buffer, comprised of Common Equity Tier 1 capital, is also established above the regulatory minimum capital requirements. This capital conservation buffer will be phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019.

The phase-in period for the final rules became effective for the Corporation on January 1, 2015, with full compliance with all of the final rules’ requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of December 31, 2016, the Corporation’s and the Banks’ capital levels remained characterized as well capitalized under the new rules.

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The following table summarizes both the Corporation's and Banks' capital ratios and the ratios required by their federal regulators at December 31, 2016 and 2015, respectively:

	Actual		Minimum Required for Capital Adequacy Purposes		For Capital Adequacy Purposes Plus Capital Conservation Buffer		Minimum Required to Be Well Capitalized Under Prompt Corrective Action Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in Thousands)							
As of December 31, 2016								
Total capital (to risk-weighted assets)								
Consolidated	$204,117	11.74%	$ 139,101	8.00 %	$149,968	8.625%	N/A	N/A
First Business Bank	147,811	11.55	102,362	8.00	110,360	8.625	$ 127,953	10.00 %
First Business Bank – Milwaukee	24,347	11.02	17,680	8.00	19,062	8.625	22,101	10.00
Alterra Bank	31,699	13.27	19,106	8.00	20,599	8.625	23,882	10.00
Tier 1 capital (to risk-weighted assets)								
Consolidated	$160,964	9.26	$ 104,326	6.00	$115,193	6.625%	N/A	N/A
First Business Bank	134,208	10.49	76,772	6.00	84,769	6.625	$ 102,362	8.00
First Business Bank – Milwaukee	22,323	10.10	13,260	6.00	14,642	6.625	17,680	8.00
Alterra Bank	28,685	12.01	14,329	6.00	15,822	6.625	19,106	8.00
Common equity tier 1 capital (to risk-weighted assets)								
Consolidated	$150,960	8.68	$ 78,244	4.50	$89,111	5.125%	N/A	N/A
First Business Bank	134,208	10.49	57,579	4.50	65,576	5.125	$ 83,170	6.50
First Business Bank – Milwaukee	22,323	10.10	9,945	4.50	11,327	5.125	14,365	6.50
Alterra Bank	28,685	12.01	10,747	4.50	12,240	5.125	15,524	6.50
Tier 1 leverage capital (to adjusted assets)								
Consolidated	$160,964	9.07	$ 70,985	4.00	$70,985	4.00 %	N/A	N/A
First Business Bank	134,208	10.40	51,600	4.00	51,600	4.00	$ 64,500	5.00
First Business Bank – Milwaukee	22,323	9.15	9,758	4.00	9,758	4.00	12,198	5.00
Alterra Bank	28,685	10.58	10,842	4.00	10,842	4.00	13,552	5.00

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	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to Be Well Capitalized Under Prompt Corrective Action Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in Thousands)					
As of December 31, 2015						
Total capital (to risk-weighted assets)						
Consolidated	$189,163	11.11%	$ 136,208	8.00 %	N/A	N/A
First Business Bank	141,388	11.12	101,754	8.00	$ 127,193	10.00 %
First Business Bank – Milwaukee	20,931	12.03	13,914	8.00	17,392	10.00
Alterra Bank	30,300	11.39	21,279	8.00	26,598	10.00
Tier 1 capital (to risk-weighted assets)						
Consolidated	$149,920	8.81 %	$ 102,156	6.00 %	N/A	N/A
First Business Bank	128,852	10.13	76,316	6.00	$ 101,754	8.00 %
First Business Bank – Milwaukee	19,172	11.02	10,435	6.00	13,914	8.00
Alterra Bank	28,278	10.63	15,959	6.00	21,279	8.00
Common equity tier 1 capital (to risk-weighted assets)						
Consolidated	$139,920	8.22 %	$ 76,617	4.50 %	N/A	N/A
First Business Bank	128,852	10.13	57,237	4.50	$ 110,669	6.50 %
First Business Bank – Milwaukee	19,172	11.02	7,826	4.50	82,675	6.50
Alterra Bank	28,278	10.63	11,969	4.50	11,305	6.50
Tier 1 leverage capital (to adjusted assets)						
Consolidated	$149,920	8.63 %	$ 69,466	4.00 %	N/A	N/A
First Business Bank	128,852	10.44	49,359	4.00	$ 61,698	5.00 %
First Business Bank – Milwaukee	19,172	7.81	9,821	4.00	12,276	5.00
Alterra Bank	28,278	9.89	11,441	4.00	14,301	5.00

The following table reconciles stockholders’ equity to federal regulatory capital at December 31, 2016 and 2015, respectively:

	As of December 31,	
	2016	2015
	(In Thousands)	
Stockholders’ equity of the Corporation	$161,650	$150,832
Net unrealized and accumulated losses on specific items	522	80
Disallowed servicing assets	(652)	(370)
Disallowed goodwill and other intangibles	(10,560)	(10,622)
Junior subordinated notes	10,004	10,000
Tier 1 capital	160,964	149,920
Allowable general valuation allowances and subordinated debt	43,153	39,243
Total capital	$204,117	$189,163

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Note 11 – Earnings per Common Share

Earnings per common share are computed using the two-class method. Basic earnings per common share are computed by dividing net income allocated to common shares by the weighted average number of shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted shares. Unvested restricted shares are considered participating securities because holders of these securities receive non-forfeitable dividends at the same rate as holders of the Corporation's common stock. Diluted earnings per share are computed by dividing net income allocated to common shares adjusted for reallocation of undistributed earnings of unvested restricted shares by the weighted average number of shares determined for the basic earnings per common share computation plus the dilutive effect of common stock equivalents using the treasury stock method.

Effective November 1, 2014, the Corporation successfully completed the acquisition of Aslin Group, Inc. and Alterra. Under the terms of the definitive agreement, the Corporation issued 720,162 shares, on a post-split basis, to Aslin Group, Inc. shareholders as the stock portion of the consideration paid. This stock issuance impacted the Corporation's earnings per share by increasing the number of shares outstanding.

For the years ended December 31, 2016 and 2015, there were no average anti-dilutive employee share-based awards. For the year ended December 31, 2014, there were four average anti-dilutive employee share-based awards. All shares and earnings per share amounts have been adjusted to reflect the 2-for-1 stock split in the form of a 100% stock dividend completed in August 2015.

	For the Year Ended December 31,		
	2016	2015	2014
	(Dollars in Thousands, Except Share Data)		
Basic earnings per common share			
Net income	$14,909	$ 16,514	$ 14,139
Less: earnings allocated to participating securities	219	273	294
Basic earnings allocated to common shareholders	$14,690	$ 16,241	$ 13,845
Weighted-average common shares outstanding, excluding participating securities	8,573,722	8,549,176	7,869,956
Basic earnings per common share	$1.71	$ 1.90	$ 1.76
Diluted earnings per common share			
Earnings allocated to common shareholders	$14,690	$ 16,241	$ 13,845
Reallocation of undistributed earnings	—	—	1
Diluted earnings allocated to common shareholders	$14,690	$ 16,241	$ 13,846
Weighted-average common shares outstanding, excluding participating securities	8,573,722	8,549,176	7,869,956
Dilutive effect of share-based awards	—	1,146	36,811
Weighted-average diluted common shares outstanding, excluding participating securities	8,573,722	8,550,322	7,906,767
Diluted earnings per common share	$1.71	$ 1.90	$ 1.75

Note 12 – Share-Based Compensation

The Corporation adopted the 2012 Equity Incentive Plan (the "Plan") during the quarter ended June 30, 2012. The Plan is administered by the Compensation Committee of the Board of Directors of the Corporation and provides for the grant of equity ownership opportunities through incentive stock options and nonqualified stock options (together, "Stock Options"), restricted stock, restricted stock units, dividend equivalent units, and any other type of award permitted by the Plan. As of December 31, 2016, 274,581 shares were available for future grants under the Plan. Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the Plan. The Corporation may issue new shares and shares from its treasury stock for shares delivered under the Plan.

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Restricted Stock

Under the Plan, the Corporation may grant restricted stock to plan participants, subject to forfeiture upon the occurrence of certain events until the dates specified in the participant's award agreement. While restricted stock is subject to forfeiture, with the exception of restricted stock units, which do not have voting rights and are provided dividend equivalents, restricted stock participants may exercise full voting rights and will receive all dividends and other distributions paid with respect to the restricted shares. The restricted stock granted under the Plan is typically subject to a vesting period. Compensation expense is recognized over the requisite service period of generally four years for the entire award on a straight-line basis. Upon vesting of restricted share awards, the benefit of tax deductions in excess of recognized compensation expense is reflected as an income tax benefit in the Consolidated Statements of Income.

Restricted stock activity for the year ended December 31, 2016, 2015 and 2014 was as follows:

	For the Year Ended December 31,					
	2016		2015		2014	
	Number of Restricted Shares	Weighted Average Grant-Date Fair Value	Number of Restricted Shares	Weighted Average Grant-Date Fair Value	Number of Restricted Shares	Weighted Average Grant-Date Fair Value
Nonvested balance at beginning of year	135,471	$ 20.13	154,998	$ 16.97	169,418	$ 11.55
Granted	60,415	22.74	53,790	22.52	64,522	22.49
Vested	(56,090)	18.71	(64,874)	15.23	(78,942)	9.86
Forfeited	(23,551)	20.90	(8,443)	15.03	—	—
Nonvested balance as of end of year	116,245	21.13	135,471	20.13	154,998	16.97

As of December 31, 2016, the Corporation had $2.2 million of deferred unvested compensation expense, which the Corporation expects to recognize over a weighted-average period of approximately 2.8 years.

For the years ended December 31, 2016, 2015 and 2014, share-based compensation expense related to restricted stock included in the Consolidated Statements of Income was as follows:

	For the Year Ended December 31,		
	2016	2015	2014
	(In Thousands)		
Share-based compensation expense	$994	$1,063	$887

Note 13 – Employee Benefit Plans

The Corporation maintains a contributory 401(k) defined contribution plan covering substantially all employees. The Corporation matches 100% of amounts contributed by each participating employee, up to 3.0% of the employee's compensation. The Corporation may also make discretionary contributions up to an additional 6.0% of salary. Contributions are expensed in the period incurred and recorded in compensation expense in the Consolidated Statements of Income. The Corporation made a matching contribution of 3.0% to all eligible employees which totaled $621,000, $573,000 and $398,000 for the years ended December 31, 2016, 2015 and 2014, respectively. Discretionary contributions of 1.2%, or $207,000, 3.3%, or $549,000, and 4.7%, or $632,000, were made in 2016, 2015 and 2014, respectively.

As of December 31, 2016, 2015 and 2014, the Corporation had a deferred compensation plan under which it provided contributions to supplement the retirement income of one executive. Under the terms of the plan, benefits to be received are generally payable within six months of the date of the termination of employment with the Corporation. The expense associated with the deferred compensation plan in 2016, 2015 and 2014 was $124,000, $116,000 and $101,000, respectively. The present value of future payments under the remaining plan of $987,000 and $863,000 at December 31, 2016 and 2015, respectively, is included in accrued interest payable and other liabilities on the Consolidated Balance Sheets.

The Corporation owned life insurance policies on the life of the executive covered by the deferred compensation plan, which had cash surrender values and death benefits of approximately $2.3 million and $5.9 million, respectively, at December 31, 2016 and cash surrender values and death benefits of approximately $2.2 million and $5.8 million, respectively, at December 31, 2015. The remaining balance of the cash surrender value of bank-owned life insurance of $36.7 million and

$26.1 million as of December 31, 2016 and 2015, respectively, is related to policies on a number of then-qualified individuals affiliated with the Banks.

Note 14 – Leases

The Corporation and FBB occupy space in Madison, Wisconsin under an operating lease agreement that expires on July 7, 2028. FBB has four loan production offices in Appleton, Oshkosh, Manitowoc and Kenosha, Wisconsin that occupy office space under separate operating lease agreements that expire on various dates between July 2017 and January 2018. In October 2016, the loan production office in Green Bay, Wisconsin was closed. FBB – Milwaukee occupies office space under an operating lease agreement that expires on November 30, 2020. Alterra occupies office space in Leawood, Kansas under an operating lease agreement that expires on May 31, 2023. The Corporation also has several specialty financing production offices under separate operating lease agreements that expire on various dates between March 2017 and September 2018. The Corporation's total rent expense was $1.8 million, $1.7 million and $1.3 million for the years ended December 31, 2016, 2015 and 2014, respectively. Rent expense is recognized on a straight-line basis. The Corporation also leases other office equipment. Rental expense for these operating leases was $136,000, $109,000 and $37,000 for the years ended December 31, 2016, 2015 and 2014, respectively.

Future minimum lease payments for noncancelable operating leases for each of the five succeeding years and thereafter are as follows:

(In Thousands)	
2017	$1,253
2018	1,072
2019	1,044
2020	1,036
2021	928
Thereafter	4,932
	$10,265

Note 15 - Other Non-Interest Expense

A summary of other non-interest expenses for the years ended December 31, 2016, 2015 and 2014 is as follows:

	Year Ended December 31,		
	2016	2015	2014
	(In Thousands)		
General and administrative expenses	$1,545	$1,759	$1,024
Travel and other employee expenses	1,354	1,277	1,069
Computer software expenses	2,160	1,649	886
Partnership income	(790)	(481)	(774)
Foreclosed properties expenses	25	52	5
Other expenses	104	295	202
Total other non-interest expense	$4,398	$4,551	$2,412

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Note 16 – Income Taxes

Income tax expense for the years ended December 31, 2016, 2015 and 2014 consists of the following:

	Year Ended December 31,		
	2016	2015	2014
	(In Thousands)		
Current:			
Federal	$2,839	$5,881	$4,235
State	425	1,338	1,459
Current tax expense	3,264	7,219	5,694
Deferred:			
Federal	(1,000)	1,036	1,299
State	(108)	122	90
Deferred tax (benefit) expense	(1,108)	1,158	1,389
Total income tax expense	$2,156	$8,377	$7,083

Deferred income tax assets and liabilities reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and their tax basis. Net deferred tax assets are included in accrued interest receivable and other assets in the Consolidated Balance Sheets.

The significant components of the Corporation's deferred tax assets and liabilities were as follows:

	December 31,	December 31,
	2016	2015
	(In Thousands)	
Deferred tax assets:		
Allowance for loan and lease losses	$8,177	$ 6,422
SBA recourse reserve	720	—
Excess book basis over tax basis for net assets acquired	336	697
Deferred compensation	951	1,305
State net operating loss carryforwards	548	666
Non-accrual loan interest	815	813
Capital loss carryforwards	32	33
Unrealized losses on securities	349	50
Other	394	342
Total deferred tax assets before valuation allowance	12,322	10,328
Valuation allowance	—	(68)
Total deferred tax assets	12,322	10,260
Deferred tax liabilities:		
Leasing and fixed asset activities	7,389	6,878
Loan servicing asset	780	612
Other	101	137
Total deferred tax liabilities	8,270	7,627
Net deferred tax asset	$4,052	$ 2,633

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The tax effects of unrealized gains and losses on securities are components of other comprehensive income. A reconciliation of the change in net deferred tax assets to deferred tax expense as of December 31, 2016, 2015 and 2014 was as follows:

	December 31, 2016	December 31, 2015	December 31, 2014
	(In Thousands)		
Change in net deferred tax assets	$1,419	$ (970)	$ (119)
Deferred taxes allocated to other comprehensive income	(311)	(188)	352
Acquired deferred tax assets	—	—	(1,622)
Deferred income tax benefit (expense)	$1,108	$ (1,158)	$ (1,389)

Realization of the deferred tax asset over time is dependent upon the Corporation generating sufficient taxable earnings in future periods. In making the determination that the realization of the deferred tax was more likely than not, the Corporation considered several factors including its recent earnings history, its expected earnings in the future, appropriate tax planning strategies and expiration dates associated with operating loss carry forwards.

The Corporation had state net operating loss carryforwards of approximately $10.7 million and $12.9 million at December 31, 2016 and 2015, respectively, which can be used to offset future state taxable income. The Corporation believes it will be able to fully utilize its Wisconsin state net operating losses under this law and therefore no valuation allowance has been established as of December 31, 2016.

The provision for income taxes differs from that computed at the federal statutory corporate tax rate as follows:

	Year Ended December 31,		
	2016	2015	2014
	(Dollars in Thousands)		
Income before income tax expense	$17,065	$24,891	$21,222
Tax expense at statutory federal rate of 35%, 34.42% and 34% applied to income before income tax expense, respectively	$5,973	$8,568	$7,305
State income tax, net of federal effect	206	968	1,000
Tax-exempt security and loan income, net of TEFRA adjustments	(1,114)	(879)	(736)
Bank-owned life insurance	(341)	(330)	(296)
Non-deductible transaction costs	—	—	124
Tax credits, net	(2,696)	(246)	(375)
Other	128	296	61
Total income tax expense	$2,156	$8,377	$7,083
Effective tax rate	12.63 %	33.65 %	33.38 %

As of December 31, 2016, there were no uncertain tax positions outstanding. The summary of all of the Corporation’s uncertain tax positions totaled $27,000 at December 31, 2015. There were no material additions to or reductions from these uncertain tax positions for the year ended December 31, 2016. As of December 31, 2016, tax years remaining open for the State of Wisconsin tax were 2012 through 2015. Federal tax years that remained open were 2013 through 2015. As of December 31, 2016, there were also no unrecognized tax benefits that are expected to significantly increase or decrease within the next twelve months.

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Note 17 – Derivative Financial Instruments

The Corporation offers interest rate swap products directly to qualified commercial borrowers. The Corporation economically hedges client derivative transactions by entering into offsetting interest rate swap contracts executed with a third party. Derivative transactions executed as part of this program are not designated as accounting hedge relationships and are marked-to-market through earnings each period. The derivative contracts have mirror-image terms, which results in the positions' changes in fair value primarily offsetting through earnings each period. The credit risk and risk of non-performance embedded in the fair value calculations is different between the dealer counterparties and the commercial borrowers which may result in a difference in the changes in the fair value of the mirror-image swaps. The Corporation incorporates credit valuation adjustments to appropriately reflect both its own non-performance risk and the counterparty's risk in the fair value measurements. When evaluating the fair value of its derivative contracts for the effects of non-performance and credit risk, the Corporation considered the impact of netting and any applicable credit enhancements such as collateral postings, thresholds and guarantees.

At December 31, 2016, the aggregate amortizing notional value of interest rate swaps with various commercial borrowers was $25.8 million. The Corporation receives fixed rates and pays floating rates based upon LIBOR on the swaps with commercial borrowers. These interest rate swaps mature between August 2018 and July 2027. Commercial borrower swaps are completed independently with each borrower and are not subject to master netting arrangements. These commercial borrower swaps were reported on the Consolidated Balance Sheets as a derivative asset of $352,000, included in accrued interest receivable and other assets. In the event of default on a commercial borrower interest rate swap by the counterparty, a right of offset exists to allow for the commercial borrower to set off amounts due against the related commercial loan. As of December 31, 2016, no interest rate swaps were in default and therefore all values for the commercial borrower swaps are recorded on a gross basis on the Consolidated Balance Sheets.

At December 31, 2016, the aggregate amortizing notional value of interest rate swaps with dealer counterparties was also $25.8 million. The Corporation pays fixed rates and receives floating rates based upon LIBOR on the swaps with dealer counterparties. These interest rate swaps mature in August 2018 through July 2027. Dealer counterparty swaps are subject to master netting agreements among the contracts within each of our Banks and are reported on the Consolidated Balance Sheets as a net derivative liability of $352,000. The value of these swaps was included in accrued interest payable and other liabilities as of December 31, 2016. The gross amount of dealer counterparty swaps was also $352,000 as no right of offset existed with the dealer counterparty swaps as of December 31, 2016.

The table below provides information about the location and fair value of the Corporation's derivative instruments as of December 31, 2016 and 2015.

	Interest Rate Swap Contracts			
	Asset Derivatives		Liability Derivatives	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
	(In Thousands)			
Derivatives not designated as hedging instruments				
December 31, 2016	Accrued interest receivable and other assets	$ 352	Accrued interest payable and other liabilities	$ 352
December 31, 2015	Accrued interest receivable and other assets	$ 552	Accrued interest payable and other liabilities	$ 552

No derivative instruments held by the Corporation for the year ended December 31, 2016 were considered hedging instruments. All changes in the fair value of these instruments are recorded in other non-interest income. Given the mirror-image terms of the outstanding derivative portfolio, the change in fair value for the years ended December 31, 2016, 2015 and 2014 had an insignificant impact to the audited Consolidated Statements of Income.

Note 18 – Commitments and Contingencies

The Banks are party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of clients. These financial instruments include commitments to extend credit and standby letters of credit and involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the Consolidated Financial

Statements. The contract amounts reflect the extent of involvement the Banks have in these particular classes of financial instruments.
In the event of non-performance, the Banks' exposure to credit loss for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Banks use the same credit policies in making commitments and conditional obligations as they do for instruments reflected in the Consolidated Financial Statements. An accrual for credit losses on financial instruments with off-balance-sheet risk would be recorded separate from any valuation account related to any such recognized financial instrument. As of December 31, 2016 and 2015, there were no accrued credit losses for financial instruments with off-balance-sheet risk.
Financial instruments whose contract amounts represent potential credit risk at December 31, 2016 and 2015, respectively, are as follows:

	At December 31,	
	2016	2015
	(In Thousands)	
Commitments to extend credit, primarily commercial loans	$539,146	$512,627
Standby letters of credit	11,771	18,622

Commitments to extend credit are agreements to lend to a client as long as there is no violation of any condition in the contract. Commitments generally have fixed expiration dates or other termination clauses and may have a fixed interest rate or a rate which varies with the prime rate or other market indices and may require payment of a fee. Since some commitments expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements of the Banks. The Banks evaluate the creditworthiness of each client on a case-by-case basis and generally extend credit only on a secured basis. Collateral obtained varies but consists primarily of commercial real estate, accounts receivable, inventory, equipment and securities. There is generally no market for commercial loan commitments, the fair value of which would approximate the present value of any fees expected to be received as a result of the commitment. These are not considered to be material to the financial statements.
Standby letters of credit are conditional commitments issued by the Banks to guarantee the performance of a client to a third party. Generally, standby letters of credit expire within one year and are collateralized by accounts receivable, equipment, inventory and commercial properties. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to clients. The fair value of standby letters of credit is recorded as a liability when the standby letter of credit is issued. The fair value has been estimated to approximate the fees received by the Banks for issuance. The fees are recorded into income and the fair value of the guarantee is decreased ratably over the term of the standby letter of credit.

In the ordinary course of business, the Corporation sells the guaranteed portion of SBA loans, as well as participation interests in other originated loans, to third parties. The Corporation has a continuing involvement in each of the transferred lending arrangements by way of relationship management, servicing the loans, as well as being subject to normal and customary requirements of the SBA loan program; however, there are no further obligations to the third-party participant required of the Corporation, other than standard representations and warranties related to sold amounts. In the event of a loss resulting from default and a determination by the SBA that there is a deficiency in the manner in which the loan was originated, funded or serviced by the Corporation, the SBA may require the Corporation to repurchase the loan, deny its liability under the guaranty, reduce the amount of the guaranty, or, if it has already paid under the guaranty, seek recovery of the principal loss related to the deficiency from the Corporation. The Corporation must comply with applicable SBA regulations in order to maintain the guaranty. In addition, the Corporation retains the option to repurchase the sold guaranteed portion of an SBA loan if the loan defaults.

Management has assessed estimated losses inherent in the outstanding guaranteed portion of SBA loans sold in accordance with ASC 450, Contingencies, and determined a recourse reserve based on the probability of future losses for these loans to be $1.7 million at December 31, 2016, which is reported in accrued interest payable and other liabilities on the Consolidated Balance Sheets. No recourse reserve was recorded as of December 31, 2015. To date, the Corporation has not experienced significant losses related to the guaranteed portion of SBA loans.

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The summary of the activity in the SBA recourse reserve for the year ended December 31, 2016 is as follows:

	At December 31, 2016 (In Thousands)
Balance at the beginning of the period	$ —
SBA recourse provision	2,068
Charge-offs, net	(318)
Balance at the end of the period	$ 1,750

In the normal course of business, various legal proceedings involving the Corporation are pending. Management, based upon advice from legal counsel, does not anticipate any significant losses as a result of these actions. Management believes that any liability arising from any such proceedings currently existing or threatened will not have a material adverse effect on the Corporation's financial position, results of operations and cash flows.

Note 19 – Fair Value Disclosures

The Corporation determines the fair values of its financial instruments based on the fair value hierarchy established in ASC Topic 820, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is defined as the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date and is based on exit prices. Fair value includes assumptions about risk, such as nonperformance risk in liability fair values, and is a market-based measurement, not an entity-specific measurement. The standard describes three levels of inputs that may be used to measure fair value.

Level 1 — Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.

Level 2 — Level 2 inputs are inputs, other than quoted prices included with Level 1, that are observable for the asset or liability either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 — Level 3 inputs are supported by little or no market activity and are significant to the fair value of the assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

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Assets and liabilities measured at fair value on a recurring basis, segregated by fair value hierarchy level, are summarized below:

	December 31, 2016 Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Assets:				
Securities available-for-sale:				
U.S. Government agency obligations - government-sponsored enterprises	$—	$6,295	$ —	$6,295
Municipal obligations	—	8,156	—	8,156
Asset backed securities	—	1,081	—	1,081
Collateralized mortgage obligations - government issued	—	31,213	—	31,213
Collateralized mortgage obligations - government-sponsored enterprises	—	99,148	—	99,148
Interest rate swaps	—	352	—	352
Liabilities:				
Interest rate swaps	—	352	—	352

	December 31, 2015 Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Assets:				
Securities available-for-sale:				
U.S. Government agency obligations - government-sponsored enterprises	$—	$8,017	$ —	$8,017
Municipal obligations	—	4,283	—	4,283
Asset backed securities	—	1,269	—	1,269
Collateralized mortgage obligations - government issued	—	44,543	—	44,543
Collateralized mortgage obligations - government-sponsored enterprises	—	82,436	—	82,436
Interest rate swaps	—	552	—	552
Liabilities:				
Interest rate swaps	—	552	—	552

For assets and liabilities measured at fair value on a recurring basis, there were no transfers between the levels during the year ended December 31, 2016 or 2015 related to the above measurements.

Assets and liabilities measured at fair value on a non-recurring basis, segregated by fair value hierarchy, are summarized below:

	December 31, 2016 Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Impaired loans	$—	$12,268	$1,097	$13,365

Foreclosed properties	—	1,473	—	1,473
Loan servicing rights	—	—	1,906	1,906

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	December 31, 2015 Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
	(In Thousands)			
Impaired loans	$—	$11,518	$6,245	$17,763
Foreclosed properties	—	1,677	—	1,677
Loan servicing rights	—	—	1,563	1,563

Impaired loans were written down to the fair value of their underlying collateral less costs to sell of $13.4 million and $17.8 million at December 31, 2016 and 2015, respectively, through the establishment of specific reserves or by recording charge-offs when the carrying value exceeded the fair value of the underlying collateral of impaired loans. Valuation techniques consistent with the market approach, income approach or cost approach were used to measure fair value and primarily included observable inputs for the individual impaired loans being evaluated such as current appraisals, recent sales of similar assets or other observable market data, and are reflected within Level 2 of the hierarchy. In cases where an input is unobservable, specifically when discounts are applied to appraisal values to adjust such values to current market conditions or to reflect net realizable value, the impaired loan balance is reflected within Level 3 of the hierarchy. The quantification of unobservable inputs for Level 3 impaired loan values range from 15% - 56%. The weighted average of those unobservable inputs as of the measurement date of December 31, 2016 was 30%. The majority of the impaired loans in the Level 3 category are considered collateral dependent loans.

Foreclosed properties, upon initial recognition, are remeasured and reported at fair value through a charge-off to the allowance for loan and lease losses, if deemed necessary, based upon the fair value of the foreclosed property. The fair value of a foreclosed property, upon initial recognition, is estimated using a market approach or Level 2 inputs based on observable market data, typically a current appraisal, or Level 3 inputs based upon assumptions specific to the individual property or equipment. Level 3 inputs typically include unobservable inputs such as management applied discounts used to further reduce values to a net realizable value and may be used in situations when observable inputs become stale. Foreclosed property fair value inputs may transition to Level 1 upon receipt of an accepted offer for the sale of the related foreclosed property.

Loan servicing rights represent the asset retained upon sale of the guaranteed portion of certain SBA loans. When SBA loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sales of loans. The servicing rights are subsequently measured using the amortization method, which requires amortization into interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

The Corporation periodically reviews this portfolio for impairment and engages a third-party valuation firm to assess the fair value of the overall servicing rights portfolio. Loan servicing rights do not trade in an active, open market with readily observable prices. While sales of loan servicing rights do occur, the precise terms and conditions typically are not readily available to allow for a “quoted price for similar assets” comparison. Accordingly, the Corporation utilizes an independent valuation from a third party which uses a discounted cash flow model to estimate the fair value of its loan servicing rights. The valuation model incorporates prepayment assumptions to project loan servicing rights cash flows based on the current interest rate scenario, which is then discounted to estimate an expected fair value of the loan servicing rights. The valuation model considers portfolio characteristics of the underlying serviced portion of the SBA loans and uses the following significant unobservable inputs: (1) constant prepayment rate (“CPR”) assumptions based on the SBA sold pools historical CPR as quoted in Bloomberg and (2) a discount rate of 10%. Due to the nature of the valuation inputs, loan servicing rights are classified in Level 3 of the fair value hierarchy.

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Fair Value of Financial Instruments

The Corporation is required to disclose estimated fair values for its financial instruments. Fair value estimates, methods and assumptions, consistent with exit price concepts for fair value measurements, are set forth below:

	December 31, 2016				
	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
	(In Thousands)				
Financial assets:					
Cash and cash equivalents	$77,517	$77,517	$55,622	$21,895	$ —
Securities available-for-sale	145,893	145,893	—	145,893	—
Securities held-to-maturity	38,612	38,520	—	38,520	—
Loans held for sale	1,111	1,111	—	1,111	—
Loans and lease receivables, net	1,429,763	1,447,044	—	12,268	1,434,776
Bank-owned life insurance	39,048	39,048	—	39,048	—
Federal Home Loan Bank and Federal Reserve Bank stock	2,131	2,131	—	2,131	—
Accrued interest receivable	4,677	4,677	4,677	—	—
Interest rate swaps	352	352	—	352	—
Financial liabilities:					
Deposits	1,538,855	1,539,413	$1,063,720	475,693	—
Federal Home Loan Bank advances and other borrowings	59,676	60,893	—	60,893	—
Junior subordinated notes	10,004	9,072	—	—	9,072
Accrued interest payable	1,765	1,765	1,765	—	—
Interest rate swaps	352	352	—	352	—
Off balance sheet items:					
Standby letters of credit	58	58	—	—	58

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	December 31, 2015				
	Carrying Amount	Fair Value			
		Total	Level 1	Level 2	Level 3
	(In Thousands)				
Financial assets:					
Cash and cash equivalents	$113,564	$113,564	$100,063	$13,501	$ —
Securities available-for-sale	140,548	140,548	—	140,548	—
Securities held-to-maturity	37,282	37,558	—	37,558	—
Loans held for sale	2,702	2,702	—	2,702	—
Loans and lease receivables, net	1,414,649	1,445,773	—	11,518	1,434,255
Bank-owned life insurance	28,298	28,298	—	28,298	—
Federal Home Loan Bank and Federal Reserve Bank stock	2,843	2,843	—	2,843	—
Accrued interest receivable	4,412	4,412	4,412	—	—
Interest rate swaps	552	552	—	552	—
Financial liabilities:					
Deposits	1,577,231	1,577,838	1,009,762	$568,076	—
Federal Home Loan Bank advances and other borrowings	34,740	35,353	—	35,353	—
Junior subordinated notes	9,990	6,614	—	—	6,614
Accrued interest payable	1,766	1,766	1,766	—	—
Interest rate swaps	552	552	—	552	—
Off balance sheet items:					
Standby letters of credit	183	183	—	—	183

Disclosure of fair value information about financial instruments, for which it is practicable to estimate that value, is required whether or not recognized in the Consolidated Balance Sheets. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Certain financial instruments and all non-financial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not necessarily represent the underlying value of the Corporation.

Cash and Cash Equivalents: The carrying amount reported for cash and due from banks and interest bearing deposits held by the Corporation approximates fair value because of its immediate availability and because it does not present unanticipated credit concerns. As of December 31, 2016 and 2015, the Corporation held $20.3 million and $9.1 million, respectively, of commercial paper. The fair value of commercial paper is classified as a Level 2 input due to the lack of available independent pricing sources. The carrying value of brokered certificates of deposit purchased approximates the fair value for these instruments. The fair value of brokered certificates of deposits purchased is based on the discounted value of contractual cash flows using a discount rate reflective of rates currently offered for deposits of similar remaining maturities. As December 31, 2016 and 2015, the Corporation held $1.6 million and $4.5 million, respectively, of brokered certificates of deposits.

Securities: The fair value measurements of investment securities are determined by a third-party pricing service which considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, trade execution data, market consensus prepayment speeds, credit information and the securities' terms and conditions, among other things. The fair value measurements are subject to independent verification by another pricing source on a quarterly basis to review for reasonableness. Any significant differences in pricing are reviewed with appropriate members of management who have the relevant technical expertise to assess the results. The Corporation has determined that these valuations are classified in Level 2 of the fair value hierarchy. When the independent pricing service does not provide a fair value measurement for a particular security, the Corporation will estimate the fair value based on specific information about each security. Fair values derived in this manner are classified in Level 3 of the fair value hierarchy.

Loans Held for Sale: Loans held for sale, which consist of residential real estate mortgage loans and the guaranteed portion of SBA loans, are carried at the lower of cost or estimated fair value. The estimated fair value is based on what secondary markets are currently offering for portfolios with similar characteristics.
Loans and Lease Receivables, net: The fair value estimation process for the loan portfolio uses an exit price concept and reflects discounts that the Corporation believes are consistent with liquidity discounts in the market place. Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing and nonperforming loans is calculated by discounting scheduled and expected cash flows through the estimated maturity using estimated market rates that reflect the credit and interest rate risk inherent in the portfolio of loans and then applying a discount factor based upon the embedded credit risk of the loan and the fair value of collateral securing nonperforming loans when the loan is collateral dependent. The estimate of maturity is based on the Banks' historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions. Significant unobservable inputs include, but are not limited to, discounts (investor yield premiums) applied to fair value calculations to further determine the exit price value of a portfolio of loans.
Federal Home Loan Bank and Federal Reserve Bank Stock: The carrying amount of FHLB and FRB stock equals its fair value because the shares may be redeemed by the FHLB and the FRB at their carrying amount of $100 per share.
Bank Owned Life Insurance: The carrying amount of the cash surrender value of life insurance approximates its fair value as the carrying value represents the current settlement amount.
Accrued Interest Receivable and Accrued Interest Payable: The carrying amounts reported for accrued interest receivable and accrued interest payable approximate fair value because of their immediate availability and because they do not present unanticipated credit concerns.
Deposits: The fair value of deposits with no stated maturity, such as demand deposits and money market accounts, is equal to the amount payable on demand. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates do not include the intangible value that results from the funding provided by deposit liabilities compared to borrowing funds in the market.
Borrowed Funds: Market rates currently available to the Corporation and Banks for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.
Interest Rate Swaps: The carrying amount and fair value of existing derivative financial instruments are based upon independent valuation models, which use widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative contract. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The Corporation incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Corporation considers the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts and guarantees.
Financial Instruments with Off-Balance-Sheet Risks: The fair value of the Corporation's off-balance-sheet instruments is based on quoted market prices and fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the credit standing of the related counterparty. Commitments to extend credit and standby letters of credit are generally not marketable. Furthermore, interest rates on any amounts drawn under such commitments would generally be established at market rates at the time of the draw. Fair value would principally derive from the present value of fees received for those products.
Limitations: Fair value estimates are made at a discrete point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holding of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could

significantly affect the estimates.

Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. In addition, the

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tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and are not considered in the estimates.

Note 20 – Condensed Parent Only Financial Information
The following represents the condensed financial information of FBFS only:
Condensed Balance Sheets

	As of December 31,	
	2016	2015
	(In Thousands)	
Assets		
Cash and due from banks	$127	$1,099
Investments in subsidiaries, at equity	196,221	187,530
Leasehold improvements and equipment, net	1,605	1,519
Other assets	4,738	2,849
Total assets	$202,691	$192,997
Liabilities and Stockholders' Equity		
Borrowed funds	$33,512	$35,751
Other liabilities	7,529	6,414
Total liabilities	41,041	42,165
Stockholders' equity	161,650	150,832
Total liabilities and stockholders' equity	$202,691	$192,997

Condensed Statements of Income

	For the Year Ended December 31,		
	2016	2015	2014
	(In Thousands)		
Net interest expense	2,799	2,777	2,071
Non-interest income			
Consulting and rental income from consolidated subsidiaries	16,036	13,398	10,776
Other	33	35	34
Total non-interest income	16,069	13,433	10,810
Non-interest expense	19,250	16,854	13,444
Loss before income tax benefit and equity in undistributed net income of consolidated subsidiaries	5,980	6,198	4,705
Income tax benefit	2,170	2,527	1,659
Loss before equity in undistributed net income of consolidated subsidiaries	3,810	3,671	3,046
Equity in undistributed net income of consolidated subsidiaries	18,719	20,185	17,185
Net income	$14,909	$16,514	$14,139

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Condensed Statements of Cash Flows

	For the Year Ended December 31,		
	2016	2015	2014
	(In Thousands)		
Operating activities			
Net income	$14,909	$16,514	$14,139
Adjustments to reconcile net income to net cash used in operating activities:			
Equity in undistributed earnings of consolidated subsidiaries	(18,719)	(20,185)	(17,185)
Share-based compensation	994	448	416
Excess tax benefit from share-based compensation	(83)	—	—
Increase in other liabilities	1,198	2,390	1,002
Other, net	(3,162)	(481)	(1,147)
Net cash used in operating activities	(4,863)	(1,314)	(2,775)
Investing activities			
Dividends received from subsidiaries	13,534	7,034	8,000
Capital contributions to subsidiaries	(3,500)	(3,000)	(32,980)
Net cash provided by (used in) investing activities	10,034	4,034	(24,980)
Financing activities			
Net (decrease) increase in short-term borrowed funds	(1,500)	1,500	1,000
Proceeds from issuance of long-term debt, net of issuance costs	—	—	14,469
Repayment of long-term debt	—	—	(4,000)
Proceeds from issuance of common stock	—	—	16,560
Proceeds from exercise of stock options	—	300	936
Purchase of treasury stock	(467)	(946)	(1,795)
Excess tax benefit from share-based compensation	—	162	305
Cash dividends paid	(4,176)	(3,816)	(3,396)
Net cash (used in) provided by financing activities	(6,143)	(2,800)	24,079
Decrease in cash and cash equivalents	(972)	(80)	(3,676)
Cash and due from banks at the beginning of the period	1,099	1,179	4,855
Cash and due from banks at the end of the period	$127	$1,099	$1,179

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Note 21 – Condensed Quarterly Earnings (unaudited)

	2016				2015			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
	(Dollars in Thousands, Except Share Data)							
Interest income	$20,321	$18,898	$19,555	$19,343	$18,600	$18,135	$17,520	$18,216
Interest expense	3,568	3,603	3,814	3,804	3,688	3,525	3,332	3,286
Net interest income	16,753	15,295	15,741	15,539	14,912	14,610	14,188	14,930
Provision for loan and lease losses	994	3,537	2,762	525	1,895	287	520	684
Non-interest income	3,931	3,640	5,823	4,594	4,935	4,102	4,126	3,848
Non-interest expense	14,523	15,753	13,458	12,699	11,684	11,984	11,974	11,732
Income (loss) before income tax expense	5,167	(355)	5,344	6,909	6,268	6,441	5,820	6,362
Income tax expense (benefit)(1)	1,199	(3,020)	1,621	2,356	2,185	2,060	1,962	2,170
Net income(1)	$3,968	$2,665	$3,723	$4,553	$4,083	$4,381	$3,858	$4,192
Per common share(2):								
Basic earnings(1)	$0.46	$0.31	$0.43	$0.52	$0.47	$0.50	$0.45	$0.48
Diluted earnings(1)	0.46	0.31	0.43	0.52	0.47	0.50	0.45	0.48
Dividends declared	0.12	0.12	0.12	0.12	0.11	0.11	0.11	0.11

(1) Results for the third quarter, second quarter and first quarter 2016 have been adjusted to reflect early adoption of ASU 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." See Note 1 for additional details related to the adjustments.

(2) All per share amounts have been adjusted to reflect the 2-for-1 stock split in the form of a 100% stock dividend completed in August 2015.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
First Business Financial Services, Inc.:

We have audited the accompanying consolidated balance sheets of First Business Financial Services, Inc. and subsidiaries (the Company) as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2016. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Business Financial Services, Inc. and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), First Business Financial Services, Inc.'s internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 10, 2017 expressed an unqualified opinion on the effectiveness of First Business Financial Services, Inc.'s internal control over financial reporting.

/s/ KPMG LLP
Chicago, Illinois
March 10, 2017

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Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

The Corporation's management, with the participation of the Corporation's Chief Executive Officer and Chief Financial Officer, has evaluated the Corporation's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based upon that evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures were effective as of December 31, 2016.

Changes in Internal Control over Financial Reporting

There was no change in the Corporation's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities and Exchange Act of 1934, as amended) that occurred during the quarter ended December 31, 2016 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

Management's Annual Report on Internal Control over Financial Reporting

The Corporation's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. The Corporation's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Corporation's financial statements for external purposes in accordance with generally accepted accounting principles.

Management, under the supervision of the Chief Executive Officer and the Chief Financial Officer, assessed the effectiveness of the Corporation's internal control over financial reporting based on criteria for effective internal control over financial reporting established in Internal Control – Integrated Framework (2013), issued by the Committee of Sponsoring Organization of the Treadway Commission (COSO). Based on this assessment, management has determined that the Corporation's internal control over financial reporting was effective as of December 31, 2016.

KPMG LLP, the independent registered public accounting firm that audited the Consolidated Financial Statements of the Corporation included in this Annual Report on Form 10-K, has issued an attestation report on the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2016. The report, which expresses an unqualified opinion on the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2016, is included under the heading "Report of Independent Registered Public Accounting Firm."

Report of Independent Registered Public Accounting Firm
The Board of Directors and Stockholders
First Business Financial Services, Inc.:

We have audited First Business Financial Services, Inc.'s (the Company) internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). First Business Financial Services, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, First Business Financial Services, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of First Business Financial Services, Inc. and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2016, and our report dated March 10, 2017 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP
Chicago, Illinois
March 10, 2017

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Item 9B. Other Information
None.

PART III.
Item 10. Directors, Executive Officers and Corporate Governance

(a) Directors of the Registrant. The information included in the definitive Proxy Statement for the Annual Meeting of the Shareholders to be held on May 23, 2017 under the captions “Item 1 - Election of Directors,” “Corporate Governance Principles and Practices” and “Section 16(a) Beneficial Ownership Reporting Compliance” is incorporated herein by reference.

(b) Executive Officers of the Registrant. The information presented in Item 1 of this document is incorporated herein by reference.

(c) Code of Ethics. The Corporation has adopted a code of ethics applicable to all employees, including the principal executive officer, principal financial officer and principal accounting officer of the Corporation. The FBFS Code of Ethics is posted on the Corporation’s website at www.firstbusiness.com. The Corporation intends to satisfy the disclosure requirements under Item 5.05(c) of Form 8-K regarding any amendment to or waiver of the code with respect to its Chief Executive Officer and Chief Financial Officer, principal accounting officer, and persons performing similar functions, by posting such information to the Corporation’s website.

Item 11. Executive Compensation
Information with respect to compensation for our directors and officers included in the definitive Proxy Statement for the Annual Meeting of the Shareholders to be held on May 23, 2017 under the captions “Executive Compensation,” “Summary Compensation Table,” “Long Term Incentive Plans,” “Outstanding Equity Awards at December 31, 2016,” “Disclosure Regarding Termination and Change in Control Provisions” and “Director Compensation” is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters
Information with respect to security ownership of certain beneficial owners and management included in the definitive Proxy Statement for the Annual Meeting of the Shareholders to be held on May 23, 2017 under the caption “Principal Shareholders” is incorporated herein by reference.

Equity Compensation Plan Information

The following table summarizes certain information with respect to compensation plans under which equity securities of the Corporation are authorized for issuance as of December 31, 2016.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)		Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	—	$	—	274,581
Equity compensation plans not approved by security holders	—	—		—

Item 13. Certain Relationships and Related Transactions, and Director Independence

Information with respect to certain relationships and related transactions included in the definitive Proxy Statement for the Annual Meeting of the Shareholders to be held on May 23, 2017 under the captions “Related Party Transactions” and “Corporate Governance Principles and Practices” is incorporated herein by reference.

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Item 14. Principal Accountant Fees and Services

Information with respect to principal accounting fees and services included in the definitive Proxy Statement for the Annual Meeting of the Shareholders to be held on May 23, 2017 under the caption “Miscellaneous” is incorporated herein by reference.

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PART IV.

Item 15. Exhibits and Financial Statement Schedules

The Consolidated Financial Statements listed on the Index included under “Item 8. Financial Statements and Supplementary Data” are filed as a part of this Form 10-K. All financial statement schedules have been included in the Consolidated Financial Statements or are either not applicable or not significant.

Exhibits. See Exhibit Index.

Item 16. Form 10-K Summary

None.

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Signatures

Pursuant to the requirements 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.

FIRST BUSINESS FINANCIAL SERVICES, INC.

March 10, 2017 /s/ Corey A. Chambas
Corey A. Chambas
Chief Executive Officer

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

Signature	Title	Date
/s/ Corey A. Chambas Corey A. Chambas	Chief Executive Officer (principal executive officer)	March 10, 2017
/s/ Edward G. Sloane, Jr. Edward G. Sloane, Jr.	Chief Financial Officer (principal financial officer)	March 10, 2017
/s/ Michael J. Murphy Michael J. Murphy	Chief Accounting Officer (principal accounting officer)	March 10, 2017
/s/ Jerome J. Smith Jerome J. Smith	Chairman of the Board of Directors	March 10, 2017
/s/ Mark D. Bugher Mark D. Bugher	Director	March 10, 2017
/s/ Jan A. Eddy Jan A. Eddy	Director	March 10, 2017
/s/ John J. Harris John J. Harris	Director	March 10, 2017
/s/ Gerald L. Kilcoyne Gerald L. Kilcoyne	Director	March 10, 2017
/s/ John M. Silseth John M. Silseth	Director	March 10, 2017
/s/ Carol P. Sanders Carol P. Sanders	Director	March 10, 2017
/s/ Dean W. Voeks Dean W. Voeks	Director	March 10, 2017

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Exhibit Index

Exhibit No.	Exhibit Name
3.1	Amended and Restated Articles of Incorporation of First Business Financial Services, Inc. (Previously filed as Exhibit 3.1 to the Annual Report on Form 10-K filed on March 13, 2009, and refiled herewith in accordance with Item 10(d) of Regulation S-K)
3.2	Amended and Restated Bylaws of First Business Financial Services, Inc. (incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed on January 31, 2012)
	Pursuant to Item 601(b)(4)(iii) of Regulation S-K, the Registrant agrees to furnish to the Securities and Exchange Commission, upon request, any instrument defining the rights of holders of long-term debt not being registered that is not filed as an exhibit to this Annual Report on Form 10-K. No such instrument authorizes securities in excess of 10% of the total assets of the Registrant.
4.1	Rights Agreement, dated as of June 5, 2008, between the Registrant and Computershare Investor Services, Inc. (Previously filed as Exhibit 4.1 to the Registration Statement on Form 8-A filed on June 6, 2008, and refiled herewith in accordance with Item 10(d) of Regulation S-K)
4.2	Form of Common Stock Certificate (incorporated by reference to Exhibit 4.3 to Amendment No. 1 to the Registration Statement on Form S-1 filed on November 26, 2012)
10.1*	2012 Equity Incentive Plan (incorporated by reference to Exhibit 10.1 to the Quarterly Report on Form 10-Q filed on July 27, 2012)
10.2*	Form of Restricted Stock Agreement (incorporated by reference to Exhibit 4.5 to the Registration Statement on Form S-8 filed on August 13, 2012)
10.3*	Form of Executive Change-in-Control and Severance Agreement (Previously filed as Exhibit 10.1 to the Current Report on Form 8-K filed on February 10, 2006, and refiled herewith in accordance with Item 10(d) of Regulation S-K)
10.4*	Amended and Restated Agreement effective December 22, 2014 between First Business Bank and Corey A. Chambas (incorporated by reference to Exhibit 10.8 of the Registrant's Annual Report on Form 10-K filed on March 16, 2015)
10.5*	First Amendment of Agreement by and between First Business Bank and Corey Chambas (Amended and Restated December 22, 2014)(incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on December 29, 2016)
10.6*	Annual Incentive Bonus Program, as amended, dated March 6, 2015 (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on March 6, 2015)
10.7*	Offer Letter between the Company and David R. Seiler. accepted March 25, 2016 (incorporated by reference to Exhibit 99.1 to the Current Report on Form 8-K filed on April 8, 2016)
21	Subsidiaries of the Registrant

23	Consent of KPMG LLP
31.1	Certification of the Chief Executive Officer

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31.2	Certification of the Chief Financial Officer
32	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350
101	The following financial information from First Business Financial Services, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets as of December 31, 2016 and December 31, 2015, (ii) Consolidated Statements of Income for the years ended December 31, 2016, 2015 and 2014, (iii) Consolidated Statements of Comprehensive Income for the years ended December 31, 2016, 2015 and 2014, (iv) Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2016, 2015 and 2014, (v) Consolidated Statements of Cash Flows for the years ended December 31, 2016, 2015 and 2014, and (vi) the Notes to Consolidated Financial Statements
*	Management contract or compensatory plan.

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