

BITSTREAM INC  
Form 10-Q  
November 14, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file Number: 0-21541

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**BITSTREAM INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of

incorporation or organization)

**245 First Street, 17<sup>th</sup> Floor, Cambridge, Massachusetts 02142-1270**

(Address of principal executive offices and zip code)

**04-2744890**  
(I.R.S. Employer

Identification No.)

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(617) 497-6222

(Registrant's telephone number, including area code)

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Indicate by checkmark 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 (the "Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Act). 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 ☒

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

On November 5, 2007, there were 10,041,320 shares of Class A Common Stock, par value \$0.01 per share issued and outstanding, and no shares of Class B Common Stock, par value \$0.01 per share, issued or outstanding.

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****BITSTREAM INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(IN THOUSANDS, EXCEPT PER-SHARE AMOUNTS)****(Unaudited)**

|                                                                                                                                   | <b>September 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|-----------------------------------------------------------------------------------------------------------------------------------|-------------------------------|------------------------------|
| <b>ASSETS</b>                                                                                                                     |                               |                              |
| Current assets:                                                                                                                   |                               |                              |
| Cash and cash equivalents                                                                                                         | \$ 15,229                     | \$ 10,542                    |
| Accounts receivable, net of allowance of \$44 and \$33 at September 30, 2007 and December 31, 2006, respectively                  | 2,505                         | 2,349                        |
| Short-term investments, prepaid expenses and other current assets                                                                 | 407                           | 410                          |
| Restricted cash                                                                                                                   | 50                            | 50                           |
| <b>Total current assets</b>                                                                                                       | <b>18,191</b>                 | <b>13,351</b>                |
| Property and equipment, net                                                                                                       | 583                           | 402                          |
| Other long-term assets:                                                                                                           |                               |                              |
| Restricted cash                                                                                                                   | 150                           | 150                          |
| Goodwill                                                                                                                          | 727                           | 727                          |
| Intangible assets, net                                                                                                            | 76                            | 87                           |
| <b>Total other assets</b>                                                                                                         | <b>953</b>                    | <b>964</b>                   |
| <b>Total assets</b>                                                                                                               | <b>\$ 19,727</b>              | <b>\$ 14,717</b>             |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                       |                               |                              |
| Current liabilities:                                                                                                              |                               |                              |
| Accounts payable                                                                                                                  | \$ 1,199                      | \$ 887                       |
| Accrued expenses                                                                                                                  | 1,284                         | 1,680                        |
| Deferred revenue                                                                                                                  | 1,669                         | 1,425                        |
| <b>Total current liabilities</b>                                                                                                  | <b>4,152</b>                  | <b>3,992</b>                 |
| Deferred rent                                                                                                                     | 68                            | 99                           |
| <b>Total liabilities</b>                                                                                                          | <b>4,220</b>                  | <b>4,091</b>                 |
| Commitments and contingencies (Note 5)                                                                                            |                               |                              |
| Stockholders' equity :                                                                                                            |                               |                              |
| Preferred stock, \$0.01 par value, Authorized 6,000 shares, Issued and outstanding- 0 at September 30, 2007 and December 31, 2006 |                               |                              |

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|                                                                                                                                                                              |           |           |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|-----------|
| Common stock, \$0.01 par value, Authorized 30,500 shares Issued 10,041 and 9,316, and outstanding 10,041 and 9,304 at September 30, 2007 and December 31, 2006, respectively | 101       | 93        |
| Additional paid-in capital                                                                                                                                                   | 36,274    | 34,252    |
| Accumulated deficit                                                                                                                                                          | (20,868)  | (23,685)  |
| Treasury stock, at cost; 0 and 12 shares at September 30, 2007 and December 31, 2006, respectively                                                                           |           | (34)      |
| Total stockholders' equity                                                                                                                                                   | 15,507    | 10,626    |
| Total liabilities and stockholders' equity                                                                                                                                   | \$ 19,727 | \$ 14,717 |

**The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.**

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**BITSTREAM INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(IN THOUSANDS, EXCEPT PER-SHARE AMOUNTS)**

**(Unaudited)**

|                                                         | <b>Three Months<br/>Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---------------------------------------------------------|-------------------------------------------------|-------------|--------------------------------------------|-------------|
|                                                         | <b>2007</b>                                     | <b>2006</b> | <b>2007</b>                                | <b>2006</b> |
| Revenue:                                                |                                                 |             |                                            |             |
| Software licenses                                       | \$ 4,699                                        | \$ 4,241    | \$ 14,189                                  | \$ 12,218   |
| Services                                                | 1,108                                           | 912         | 3,146                                      | 2,482       |
| Total revenue                                           | 5,807                                           | 5,153       | 17,335                                     | 14,700      |
| Cost of revenue:                                        |                                                 |             |                                            |             |
| Software licenses                                       | 1,779                                           | 1,544       | 5,190                                      | 4,420       |
| Services                                                | 434                                             | 395         | 1,410                                      | 1,129       |
| Cost of revenue                                         | 2,213                                           | 1,939       | 6,600                                      | 5,549       |
| Gross profit                                            | 3,594                                           | 3,214       | 10,735                                     | 9,151       |
| Operating expenses:                                     |                                                 |             |                                            |             |
| Marketing and selling                                   | 974                                             | 769         | 2,937                                      | 2,372       |
| Research and development                                | 1,223                                           | 1,055       | 3,514                                      | 3,173       |
| General and administrative                              | 666                                             | 539         | 1,870                                      | 1,593       |
| Total operating expenses                                | 2,863                                           | 2,363       | 8,321                                      | 7,138       |
| Operating income                                        | 731                                             | 851         | 2,414                                      | 2,013       |
| Legal fee reimbursement                                 |                                                 |             |                                            | 464         |
| Interest and other income, net                          | 156                                             | 93          | 424                                        | 154         |
| Total other income and expense                          | 156                                             | 93          | 424                                        | 618         |
| Income before (benefit from) provision for income taxes | 887                                             | 944         | 2,838                                      | 2,631       |
| (Benefit from) provision for income taxes               | 11                                              | (9)         | 21                                         | 27          |
| Net income                                              | \$ 876                                          | \$ 953      | \$ 2,817                                   | \$ 2,604    |
| Basic net income per share                              | \$ 0.09                                         | \$ 0.10     | \$ 0.29                                    | \$ 0.29     |
| Diluted net income per share                            | \$ 0.08                                         | \$ 0.09     | \$ 0.26                                    | \$ 0.25     |
| Basic weighted average shares outstanding               | 10,036                                          | 9,158       | 9,756                                      | 8,978       |
| Diluted weighted average shares outstanding             | 10,963                                          | 10,575      | 10,992                                     | 10,547      |

**The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.**

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**BITSTREAM INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(IN THOUSANDS) (Unaudited)**

|                                                                                   | <b>Nine Months Ended<br/>September 30,</b> |             |
|-----------------------------------------------------------------------------------|--------------------------------------------|-------------|
|                                                                                   | <b>2007</b>                                | <b>2006</b> |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                            |             |
| Net income                                                                        | \$ 2,817                                   | \$ 2,604    |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                            |             |
| Depreciation                                                                      | 188                                        | 151         |
| Amortization                                                                      | 34                                         | 46          |
| Share based compensation                                                          | 385                                        | 199         |
| Changes in operating assets and liabilities:                                      |                                            |             |
| Accounts receivable                                                               | (156)                                      | (84)        |
| Prepaid expenses and other assets                                                 | 3                                          | (13)        |
| Accounts payable                                                                  | 312                                        | 357         |
| Accrued expenses                                                                  | (396)                                      | (336)       |
| Deferred revenue                                                                  | 244                                        | 365         |
| Deferred rent                                                                     | (31)                                       | (4)         |
| Net cash provided by operating activities                                         | 3,400                                      | 3,285       |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                            |             |
| Purchases of property and equipment, net                                          | (369)                                      | (154)       |
| Additions to intangible assets                                                    | (23)                                       | (21)        |
| Net cash used in investing activities                                             | (392)                                      | (175)       |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                            |             |
| Proceeds from exercise of stock options/warrants                                  | 1,679                                      | 1,245       |
| Net cash provided by financing activities                                         | 1,679                                      | 1,245       |
| Net Increase in Cash and Cash Equivalents                                         | 4,687                                      | 4,355       |
| Cash and Cash Equivalents, beginning of period                                    | 10,542                                     | 5,464       |
| Cash and Cash Equivalents, end of period                                          | \$ 15,229                                  | \$ 9,819    |

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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**BITSTREAM INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(1) Operations and Significant Accounting Policies**

Bitstream Inc. (together with its subsidiaries, Bitstream or the Company) is a software development company focused on bringing unique software products to a wide variety of markets. Today, our core software products include award-winning fonts and font rendering technologies, mobile browsing and messaging technologies and variable data publishing and Web-to-print technologies. Visit Bitstream on the Web at <http://www.bitstream.com>. Information included on our website is not incorporated into this Form 10-Q.

We are subject to risks common to technology-based companies, including dependence on key personnel, rapid technological change, competition from alternative product offerings and larger companies, and challenges to the development and marketing of commercial products and services. We have also experienced net losses in prior years and as of September 30, 2007 have an accumulated deficit of \$20.9 million.

The accompanying condensed consolidated financial statements reflect the application of certain accounting policies as described in this note and elsewhere in the accompanying condensed consolidated financial statements and notes. The preparation of the accompanying condensed consolidated financial statements requires the use of certain estimates by us in determining our assets, liabilities, revenues and expenses. Actual results may differ from these estimates.

**(a) Basis of Presentation**

Our condensed consolidated financial statements presented herein, without audit, have been prepared pursuant to the rules of the Securities and Exchange Commission (the SEC) for quarterly reports on Form 10-Q and do not include all of the information and footnote disclosures required by generally accepted accounting principles (GAAP). The balance sheet information at December 31, 2006 has been derived from our audited consolidated financial statements but does not include all disclosures required by GAAP. These statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2006 included in our Annual Report on Form 10-K, which was filed with the SEC on March 30, 2007. The condensed consolidated balance sheet as of September 30, 2007, the condensed consolidated statements of operations for the three and nine month periods ended September 30, 2007 and 2006, and the condensed consolidated statement of cash flows for the nine months ended September 30, 2007 and 2006, and the notes to each are unaudited, but in the opinion of management include all adjustments necessary for a fair presentation of the condensed consolidated financial position, results of operations, and cash flows of the Company for these interim periods.

The results of operations for the nine months ended September 30, 2007 may not necessarily be indicative of the results to be expected for the year ending December 31, 2007.

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**BITSTREAM INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(b) Income Taxes (in thousands)**

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes* ( SFAS 109 ). Under the liability method in accordance with SFAS 109, a deferred tax asset or liability is determined based on the difference between the financial statement and the tax bases of assets and liabilities, as measured by enacted tax rates in effect when these differences are expected to reverse. We have determined that it is more likely than not that the deferred tax assets will not be realized and, therefore, a valuation allowance has reduced the deferred tax assets to \$0.

Our tax provision for the three and nine months ended September 30, 2007 consisted of \$11 and \$21 of foreign withholding taxes respectively. The Company did not have a provision for U.S. Federal tax during these periods due to Net Operating Loss ( NOL ) and Tax Credit carry forwards. The tax provision for the three and nine month periods ended September 30, 2006 included an \$(11) benefit in U.S. Federal income tax due to a refund of alternative minimum tax and \$23 expense for U.S. Federal alternative minimum tax and \$2 and \$4, respectively, of foreign withholding taxes. Foreign taxes vary with OEM license royalties from customers in countries who are party to tax conventions with the United States, including Korea and Poland.

We adopted the provisions of Financial Standards Accounting Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), an interpretation of SFAS 109 on January 1, 2007. As a result of the implementation of FIN 48, we recognized no material adjustment in the liability for unrecognized income tax benefits. At the adoption date of January 1, 2007 and also at September 30, 2007, we had no unrecognized tax benefits.

We recognize interest and penalties related to uncertain tax positions in income tax expense. As of September 30, 2007, we had no accrued interest or penalties related to uncertain tax positions.

The tax years 2003 through 2006 remain open to examination by the major taxing jurisdictions to which we are subject.

As of December 31, 2006, we had federal and state NOL carryforwards of approximately \$14,085 and \$6,679, respectively, and federal and state research and development ( R&D ) credit carryforwards of approximately \$834 and \$292, respectively, which can be used to offset future federal and state income tax liabilities and which expire at various dates through 2016. Foreign tax credit carryforwards of approximately \$404 can be used to offset future federal tax liabilities and expire at various dates through 2011.

Utilization of NOL and R&D credit carryforwards may be subject to a substantial annual limitation due to ownership changes that have occurred previously or that could occur in the future. Section 382 of the Internal Revenue Code of 1986, as well as similar state tax law provisions may limit the amount of NOL and R&D credit carryforwards that can be utilized annually to offset future taxable income and tax, respectively. Until a study is completed and any limitation known, no amounts are being presented as an uncertain tax position under FIN 48.

**(c) Cash and Cash Equivalents**

As of September 30, 2007, cash and cash equivalents included bank deposits and money market instruments. We consider all highly liquid investments with original maturities of three months or less at the time of acquisition to be cash equivalents and record such investments at cost, which approximates market value.

**Table of Contents****BITSTREAM INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(d) Property and Equipment (in thousands)**

Property and equipment are stated at cost, less accumulated depreciation and amortization. Property and equipment consists of the following:

|                                                | September 30,<br>2007 | December 31,<br>2006 |
|------------------------------------------------|-----------------------|----------------------|
| Equipment and computer software                | \$ 1,902              | \$ 3,049             |
| Purchased software                             | 436                   | 441                  |
| Furniture and fixtures                         | 359                   | 399                  |
| Leasehold improvements                         | 140                   | 120                  |
|                                                | 2,837                 | 4,009                |
| Less Accumulated depreciation and amortization | 2,254                 | 3,607                |
| Property and equipment, net                    | \$ 583                | \$ 402               |

Depreciation is provided on a straight-line basis over the estimated useful lives of the related assets as follows:

| Asset Classification            | Estimated Useful Life |
|---------------------------------|-----------------------|
| Equipment and computer software | 3 Years               |
| Purchased software              | 3 Years               |
| Furniture and fixtures          | 5 Years               |
| Leasehold improvements          | Life of lease         |

Depreciation expense for the three months ended September 30, 2007 and 2006 was \$71 and \$50, respectively. Depreciation expense for the nine months ended September 30, 2007 and 2006 was \$188 and \$151, respectively. During the third quarter of 2007 the Company inventoried and disposed of certain fully depreciated assets which were no longer in use that had an original cost basis of approximately \$1,541.

**(e) Off-Balance Sheet Risk and Concentration of Credit Risk**

Financial instruments that potentially expose us to concentrations of credit risk consist primarily of cash and cash equivalents and trade accounts receivable. We place a majority of our cash investments in one highly-rated financial institution, the balance of which may exceed federally insured deposit limits. We have not experienced significant losses related to receivables from any individual customers or groups of customers in any specific industry or by geographic area. Due to these factors, no additional credit risk beyond amounts provided for collection losses is believed by us to be inherent in our accounts receivable. At September 30, 2007, two customers each accounted for 13% of our accounts receivable. We do not have any off-balance sheet risks as of September 30, 2007. At December 31, 2006, two customers accounted for 13% and 10% of our accounts receivable, respectively. No single customer accounted for 10% or more of our revenue for the three and nine month periods ended September 30, 2007 or September 30, 2006.

**Table of Contents****BITSTREAM INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(f) Goodwill and Other Intangible Assets (in thousands)**

We follow the accounting and reporting requirements for goodwill and other intangible assets as required by SFAS No. 142, *Goodwill and Other Intangible Assets* ( SFAS 142 ). Under SFAS No. 142, goodwill and indefinite-lived intangible assets are not amortized, but are required to be reviewed annually for impairment, or more frequently, if impairment indicators arise. We have determined that we do not have separate reporting units and thus goodwill is combined and valued based upon an enterprise wide valuation. Separable intangible assets that have finite lives are amortized over their useful lives. The components of the Company's amortized intangible assets follow:

|                   | September 30, 2007          |                             |                           | December 31, 2006           |                             |                           |
|-------------------|-----------------------------|-----------------------------|---------------------------|-----------------------------|-----------------------------|---------------------------|
|                   | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |
| Marketing-related | \$ 84                       | \$ (77)                     | \$ 7                      | \$ 76                       | \$ (76)                     | \$ 0                      |
| Technology-based  | 547                         | (478)                       | 69                        | 531                         | (444)                       | 87                        |
| <b>Total</b>      | <b>\$ 631</b>               | <b>\$ (555)</b>             | <b>\$ 76</b>              | <b>\$ 607</b>               | <b>\$ (520)</b>             | <b>\$ 87</b>              |

Amortization expense for finite-lived intangible assets for the three months ended September 30, 2007 and 2006 was \$9 and \$12, respectively. Amortization expense for finite-lived intangible assets for the nine months ended September 30, 2007 and 2006 was \$34 and \$46, respectively. Estimated amortization for the five succeeding years follows:

**Estimated Amortization Expense:**

|                 |              |
|-----------------|--------------|
| 2007, remainder | \$ 9         |
| 2008            | 32           |
| 2009            | 16           |
| 2010            | 11           |
| 2011            | 8            |
|                 | <b>\$ 76</b> |

**(g) Comprehensive Income**

SFAS No. 130, *Reporting Comprehensive Income*, establishes standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Our comprehensive income is equal to our net income for all periods presented.

**(h) Reclassifications**

Certain prior account balances have been reclassified to be consistent with the current period's presentation.

**Table of Contents****BITSTREAM INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(i) Recently Issued Accounting Standards**

In September 2006, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157) which defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in GAAP and expands disclosure related to the use of fair value measures in financial statements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The adoption of SFAS 157 is not expected to have a material impact on our financial position, results of operations or cash flows.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently assessing the provisions of SFAS 159.

**(2) Income Per Share (in thousands)**

Basic earnings per share is determined by dividing the net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflect the effect of the conversion of potentially dilutive securities, such as stock options and warrants, based on the treasury stock method. In computing diluted earnings per share, common stock equivalents are not considered in periods in which a net loss is reported, as the inclusion of the common stock equivalents would be antidilutive. A reconciliation of basic and diluted weighted average shares outstanding for basic and diluted earnings per share is as follows:

|                                                     | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|-----------------------------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                                     | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                                                     | <b>2007</b>               | <b>2006</b> | <b>2007</b>              | <b>2006</b> |
| Basic weighted average shares outstanding           | 10,036                    | 9,158       | 9,756                    | 8,978       |
| Dilutive effect of options                          | 927                       | 1,405       | 1,230                    | 1,555       |
| Dilutive effect of warrants                         |                           | 12          | 5                        | 14          |
| Dilutive effect of unvested restricted shares       |                           |             | 1                        |             |
| Shares used to compute diluted net income per share | 10,963                    | 10,575      | 10,992                   | 10,547      |

In addition, there were warrants and options outstanding to purchase 488 and 227 shares for the three and nine month periods ended September 30, 2007, respectively, and 216 shares for the three and nine month periods ended September 30, 2006, that were not included in the potential common share computations because their exercise prices were greater than the average market price of our common stock.

**Table of Contents****BITSTREAM INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(3) Equity-Based Compensation Expense (in thousands )**

We currently estimate the fair value of share-based awards using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of share-based awards include the exercise price of the award, the expected option term, the expected volatility of our stock over the option's expected term, the risk-free interest rate over the option's expected term, and our expected annual dividend yield. We do not anticipate paying any cash dividends in the foreseeable future and, therefore, use an expected dividend yield of zero in the option valuation model. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. We believe that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of our stock options. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards. These amounts, and the amounts applicable to future quarters, are also subject to future quarterly adjustments based upon a variety of factors, which include but are not limited to, the issuance of new share-based awards.

The following table summarizes the weighted average assumptions we utilized for grants of share-based awards in the three and nine month periods ended September 30, 2007:

|                          | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
|                          | <b>2007</b>                                 | <b>2006</b> | <b>2007</b>                                | <b>2006</b> |
| Risk-free interest rates | 4.60%                                       | 4.90%       | 4.60%                                      | 4.90%       |
| Expected dividend yield  | None                                        | None        | None                                       | None        |
| Expected term            | 5.75 Years                                  | 5 Years     | 5.5 to 5.75 Years                          | 5 Years     |
| Expected volatility      | 87.67%                                      | 92.05%      | 87.67 to 89.23%                            | 92.05%      |

All share-based awards granted have a contractual ten year term. All options granted vest in equal installments on the first, second, third, and fourth year anniversaries over a four year period of continuous employee service. All restricted shares granted vest in equal installments on the first, second, third, fourth, and fifth year anniversaries over a five year period of continuous employee service. The risk free interest rate utilized is based upon published U.S. Treasury yield curves at the date of the grant for the expected option term. Expected stock price volatility is based upon the historical volatility of our common stock price over the expected term of the option. We use historical exercise, forfeiture, and cancellation information to determine expected term and forfeiture rates.

**Table of Contents****BITSTREAM INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Our results for the three and nine month periods ended September 30, 2007 include \$168 and \$385, and for the three and nine month periods ended September 30, 2006 include \$83 and \$199 respectively, of share-based compensation within the applicable expense classification where we report the share-based award holders' compensation cost. The following table presents share-based compensation expense included in our condensed consolidated statement of operations:

|                                             | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
|                                             | <b>2007</b>                                 | <b>2006</b> | <b>2007</b>                                | <b>2006</b> |
| Cost of revenue - software licenses         | \$ 1                                        | \$          | \$ 3                                       | \$          |
| Cost of revenue - services                  | 16                                          | 4           | 49                                         | 11          |
| Marketing and selling                       | 10                                          | 20          | (2)                                        | 56          |
| Research and development                    | 70                                          | 16          | 157                                        | 28          |
| General and administrative                  | 71                                          | 43          | 178                                        | 104         |
| Share-based compensation expense before tax | 168                                         | 83          | 385                                        | 199         |
| Income tax benefit                          |                                             |             |                                            |             |
| Net compensation expense                    | \$ 168                                      | \$ 83       | \$ 385                                     | \$ 199      |

**(4) Accrued Expenses, (in thousands):**

Accrued expenses consist of the following:

|                                              | <b>September 30, 2007</b> | <b>December 31, 2006</b> |
|----------------------------------------------|---------------------------|--------------------------|
| Payroll and other compensation               | \$ 872                    | \$ 1,279                 |
| Accrued professional and consulting services | 230                       | 187                      |
| Deferred rent                                | 47                        | 90                       |
| Accrued royalties                            | 24                        | 69                       |
| Other                                        | 111                       | 55                       |
| Total                                        | \$ 1,284                  | \$ 1,680                 |

**(5) Commitments and Contingencies, (in thousands):****Lease commitments**

We conduct our operations in leased facilities. In August 2003, we entered into a six-year lease agreement and moved our corporate offices. Our current lease agreement commenced on September 1, 2003 and obligated us to make minimum lease payments plus our pro-rata share of future real estate tax increases and certain operating expense increases above the base year. This lease agreement also required us to obtain a Letter of Credit in the amount of \$250, which resulted in \$250 in cash being classified as restricted on our Balance Sheet. The amount was reduced to \$200 on the second anniversary of the lease and will be reduced further to \$150 on the fourth anniversary of the lease.

**Royalties**

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We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is primarily based on a dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense is recorded under our cost of software license revenue on our consolidated Statement of Operations.

**Table of Contents****BITSTREAM INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Indemnification**

We enter into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally business partners or customers, in connection with any U.S. patent, or any copyright or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal.

**Legal Actions**

From time to time we are subject to legal proceedings and claims in the ordinary course of business, including claims of infringement of third-party patents and other intellectual property rights, commercial, employment and other matters. In accordance with GAAP, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. This provision is reviewed at least quarterly. As of September 30, 2007 no liability was recorded. Litigation is inherently unpredictable and it is possible that our financial position, cash flows, or results of operations could be materially affected in any particular period by the occurrence or resolution of any such contingencies or the costs involved in seeking the resolution of any such contingencies.

**(6) Geographical Reporting ( in thousands):**

We attribute revenues to different geographical areas on the basis of the location of the customer. All of our product sales for the three and nine month periods ended September 30, 2007 and 2006 were shipped from our headquarters located in the United States. Revenues by geographic area are as follows:

|                                                        | <b>Three Months Ended<br/>September 30,</b> |                 | <b>Nine Months Ended<br/>September 30,</b> |                  |
|--------------------------------------------------------|---------------------------------------------|-----------------|--------------------------------------------|------------------|
|                                                        | <b>2007</b>                                 | <b>2006</b>     | <b>2007</b>                                | <b>2006</b>      |
| <b>*Revenue:</b>                                       |                                             |                 |                                            |                  |
| United States                                          | \$ 4,710                                    | \$ 4,250        | \$ 14,371                                  | \$ 12,455        |
| Canada                                                 | 384                                         | 498             | 666                                        | 783              |
| United Kingdom (UK)                                    | 249                                         | 128             | 866                                        | 314              |
| Other (Countries less than 5% individually, by Region) |                                             |                 |                                            |                  |
| Europe, excluding UK                                   | 264                                         | 224             | 935                                        | 776              |
| Asia                                                   | 180                                         | 47              | 351                                        | 343              |
| Other                                                  | 20                                          | 6               | 146                                        | 29               |
| <b>Total revenue</b>                                   | <b>\$ 5,807</b>                             | <b>\$ 5,153</b> | <b>\$ 17,335</b>                           | <b>\$ 14,700</b> |

\* If revenue attributable to a specific country is greater than 5% in any period, revenue attributable to that country is disclosed for all periods. E-commerce credit card revenue is all included as attributable to the United States.

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**PART I, ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto.

**OVERVIEW**

Bitstream Inc. was incorporated in the State of Delaware in 1981. Bitstream Inc. (together with its subsidiaries, Bitstream or the Company) is a software development company focused on bringing unique software products to a wide variety of markets. Today, our core software products include award-winning fonts and font rendering technologies, mobile browsing and messaging technologies and variable data publishing and Web-to-print technologies.

We maintain our executive offices at 245 First Street, 17<sup>th</sup> Floor, Cambridge, Massachusetts 02142-1270. Our telephone number is (617) 497-6222 and we maintain websites at [www.bitstream.com](http://www.bitstream.com), [www.myfonts.com](http://www.myfonts.com), and [www.pageflex.com](http://www.pageflex.com). Investors may obtain copies of our filings with the Securities and Exchange Commission (the SEC) free of charge from our website at [www.bitstream.com](http://www.bitstream.com) or from the SEC's website at [www.sec.gov](http://www.sec.gov).

**CRITICAL ACCOUNTING POLICIES**

We incorporate herein by reference the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operation Critical Accounting Policies contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 and filed with the SEC on March 30, 2007. No changes have been made to these policies since December 31, 2006.

**FORWARD LOOKING STATEMENTS**

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended (the

Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward-looking statements generally are identified by the words believes, project, expects, anticipates, estimates, intends, strategy, plan, may, will, will likely result, and similar expressions. Investors are cautioned that forward-looking statements are inherently uncertain. Actual performance and results of operations may differ materially from those projected or suggested in the forward-looking statements due to certain risks and uncertainties, including, without limitation, market acceptance of our products, competition and the timely introduction of new products. Additional information concerning certain risks and uncertainties that would cause actual results to differ materially from those projected or suggested in the forward-looking statements is contained in our filings with the SEC, including those risks and uncertainties discussed under the section entitled Forward Looking Statements contained in our Annual Report on Form 10-K filed with the SEC on March 30, 2007. The forward-looking statements contained herein represent our judgment as of the date of this report, and we caution readers not to place undue reliance on such statements. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

**Table of Contents****RESULTS OF OPERATIONS (in thousands, except percentages)****Revenue and Gross Profit:**

|                        | Three Months Ended September 30, |                 |          |                 |                   |         |
|------------------------|----------------------------------|-----------------|----------|-----------------|-------------------|---------|
|                        | 2007                             | % of<br>Revenue | 2006     | % of<br>Revenue | Change<br>Dollars | Percent |
| <b>Revenue</b>         |                                  |                 |          |                 |                   |         |
| Software licenses      | \$ 4,699                         | 80.9%           | \$ 4,241 | 82.3%           | \$ 458            | 10.8%   |
| Services               | 1,108                            | 19.1            | 912      | 17.7            | 196               | 21.5    |
| Total revenue          | 5,807                            | 100.0           | 5,153    | 100.0           | 654               | 12.7    |
| <b>Cost of Revenue</b> |                                  |                 |          |                 |                   |         |
| Software licenses      | 1,779                            | 37.9            | 1,544    | 36.4            | 235               | 15.2    |
| Services               | 434                              | 39.2            | 395      | 43.3            | 39                | 9.9     |
| Total cost of revenue  | 2,213                            | 38.1            | 1,939    | 37.6            | 274               | 14.1    |
| <b>Gross Profit</b>    | \$ 3,594                         | 61.9%           | \$ 3,214 | 62.4%           | \$ 380            | 11.8%   |

|                        | Nine Months Ended September 30, |                 |           |                 |                   |         |
|------------------------|---------------------------------|-----------------|-----------|-----------------|-------------------|---------|
|                        | 2007                            | % of<br>Revenue | 2006      | % of<br>Revenue | Change<br>Dollars | Percent |
| <b>Revenue</b>         |                                 |                 |           |                 |                   |         |
| Software licenses      | \$ 14,189                       | 81.9%           | \$ 12,218 | 83.1%           | \$ 1,971          | 16.1%   |
| Services               | 3,146                           | 18.1            | 2,482     | 16.9            | 664               | 26.8    |
| Total revenue          | 17,335                          | 100.0           | 14,700    | 100.0           | 2,635             | 17.9    |
| <b>Cost of Revenue</b> |                                 |                 |           |                 |                   |         |
| Software licenses      | 5,190                           | 36.6            | 4,420     | 36.2            | 770               | 17.4    |
| Services               | 1,410                           | 44.8            | 1,129     | 45.5            | 281               | 24.9    |
| Total cost of revenue  | 6,600                           | 38.1            | 5,549     | 37.7            | 1,051             | 18.9    |
| <b>Gross Profit</b>    | \$ 10,735                       | 61.9%           | \$ 9,151  | 62.3%           | \$ 1,584          | 17.3%   |

License revenue from direct sales, which includes e-commerce sales, increased \$504, or 18.5%, to \$3,228 for the three months ended September 30, 2007 as compared to \$2,724 for the three months ended September 30, 2006, and increased \$1,568, or 19.2%, to \$9,734 for the nine months ended September 30, 2007 as compared to \$8,166 for the nine months ended September 30, 2006. License revenue from resellers increased \$52, or 17%, to \$357 for the three months ended September 30, 2007 as compared to \$305 for the three months ended September 30, 2006, and increased \$19, or 1.7%, to \$1,156 for the nine months ended September 30, 2007 as compared to \$1,137 for the nine months ended September 30, 2006. License revenue from OEMs and ISVs decreased \$98, or 8.1%, to \$1,114 for the three months ended September 30, 2007 as compared to \$1,212 for the three months ended September 30, 2006, and increased \$384, or 13.2%, to \$3,299 for the nine months ended September 30, 2007 as compared to \$2,915 for the nine months ended September 30, 2006. License revenue varies between quarters due to the timing of license agreements. Direct & reseller license revenue increased due to increases in the volume and variety of fonts and publishing products licensed during the first nine months of 2007. The increase in OEM and ISV revenue for the first nine months of 2007 was due to an increase in new licenses, as well as an increase in license renewals and royalties received under existing license agreements resulting from increases in reported unit shipments by certain OEM customers, despite a decrease for the quarter ended September 30, 2007. We believe that new customer acquisition, current customers adding licenses for existing and new products and additional unit shipments by OEM customers will result in increased revenue for the remainder of 2007 as compared to 2006.



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The increase in revenue from services was primarily due to increases in maintenance contracts associated with our publishing product line. Service revenue increased \$196, or 21.5%, to \$1,108 for the three months ended September 30, 2007 as compared to \$912 for the three months ended September 30, 2006, and increased \$664, or 26.8%, to \$3,146 for the nine months ended September 30, 2007 as compared to \$2,482 for the nine months ended September 30, 2006. These increases were primarily driven by increases in our customer base and customer demand for consulting and design services, partially offset by a decrease in service revenue from OEMs and ISVs, which decreased \$48, or 12.3%, to \$341 for the nine months ended September 30, 2007 as compared to \$389 for the nine months ended September 30, 2006. We believe that our overall services revenue during 2007 will continue to exceed the level attained during 2006.

We recognize license revenue from direct sales and licensing our products and products from third parties including e-commerce sales made via our websites, from licensing agreements with OEMs and ISVs, and from the resale of our products through various resellers. We recognize reseller revenue if collection is probable, upon notification from the reseller that it has sold the product or, if for a physical product, upon delivery of the software. E-commerce sales include revenue from the licensing of Bitstream fonts and font technology, licensing of the ThunderHawk browser, licensing of fonts and font technology developed by third parties and from fees received from referring customers to other sites for which we have referral agreements. Referral income for the three months ended September 30, 2007 and 2006 was \$7 and \$5, respectively. Referral income for the nine months ended September 30, 2007 and 2006 was \$23 and \$16, respectively. There are minimal costs associated with referral revenue, and such costs primarily represent the time to load copies of the fonts provided by each participating foundry to the MyFonts.com database. We expense those costs as incurred.

The increase in cost of license revenue for the three and nine month periods ended September 30, 2007 as compared to the same periods ended September 30, 2006 was primarily due to an increase in direct costs, including royalty and credit card processing expenses, in connection with increased e-commerce sales and increased sales of third party products for the three and nine month periods ended September 30, 2007, of \$202 and \$730, respectively. We expect the cost of license revenue as a percentage of revenue for 2007 will approximate that of the first nine months of 2007, though the results may vary based upon the mix of products sold during the year.

The increase in cost of services revenue for the three and nine month periods ended September 30, 2007 as compared to the same periods ended September 30, 2006 was due to an increase in customer consulting resources and support personnel plus a decrease in the utilization of customer support and consulting personnel on internal research and development projects for the three and nine month periods ended September 30, 2007, totaling \$33 and \$242, respectively. Total cost of services decreased slightly as a percentage of services revenue for the three and nine months ended September 30, 2007 as compared to the same periods in 2006. We expect our cost of services to increase as a percentage of sales during the last quarter of 2007 as we continue to invest in our infrastructure.

Cost of revenue includes royalties and fees paid to third parties for the development of, or license of rights to, technology and/or unique typeface designs, costs incurred in the fulfillment of custom orders, costs incurred in providing customer support, maintenance, and training, and costs associated with the duplication, packaging and shipping of product.

**Table of Contents****Operating Expenses:**

|                            | Three Months Ended September 30, |              |          |              |                |                |
|----------------------------|----------------------------------|--------------|----------|--------------|----------------|----------------|
|                            | 2007                             | % of Revenue | 2006     | % of Revenue | Change Dollars | Change Percent |
| Marketing and selling      | \$ 974                           | 16.8%        | \$ 769   | 14.9%        | \$ 205         | 26.7%          |
| Research and development   | 1,223                            | 21.1         | 1,055    | 20.5         | 168            | 15.9           |
| General and administrative | 666                              | 11.5         | 539      | 10.5         | 127            | 23.6           |
| Total operating expenses   | \$ 2,863                         | 49.3%        | \$ 2,363 | 45.9%        | \$ 500         | 21.2%          |

|                            | Nine Months Ended September 30, |              |          |              |                |                |
|----------------------------|---------------------------------|--------------|----------|--------------|----------------|----------------|
|                            | 2007                            | % of Revenue | 2006     | % of Revenue | Change Dollars | Change Percent |
| Marketing and selling      | \$ 2,937                        | 16.9%        | \$ 2,372 | 16.1%        | \$ 565         | 23.8%          |
| Research and development   | 3,514                           | 20.3         | 3,173    | 21.6         | 341            | 10.7           |
| General and administrative | 1,870                           | 10.8         | 1,593    | 10.8         | 277            | 17.4           |
| Total operating expenses   | \$ 8,321                        | 48.0%        | \$ 7,138 | 48.6%        | \$ 1,183       | 16.6%          |

Marketing and selling ( M&S ) expense consists primarily of salaries and benefits, commissions, travel expense and facilities costs related to sales and marketing personnel, as well as marketing program-related costs including trade shows and advertising. The increase in M&S expense for the three months ended September 30, 2007 as compared to the three months ended September 30, 2006 was primarily the result of a \$85 increase in salaries, wages and benefits due to an increase in headcount and commissions, a \$55 increase in advertising and marketing activities including tradeshow participation, a \$33 increase in professional services plus a \$31 increase in travel related expenses. The increase in M&S expense for the nine months ended September 30, 2007 as compared to the nine months ended September 30, 2006 was primarily the result of a \$313 increase in salaries, wages and benefits due to an increase in headcount and commissions due to the increase in commissionable sales, a \$140 increase in advertising and marketing activities including tradeshow participation, a \$57 increase in professional services, and a \$58 increase in travel related expenses. We expect that M&S expense will continue to increase during 2007 as we continue to add sales personnel and increase marketing activities to support a growing revenue and customer base.

Research and development ( R&D ) expense consists primarily of salary and benefit costs, contracted third-party development costs, and facility costs related to software developers and management. The increase in R&D expense for the three months ended September 30, 2007 as compared to the three months ended September 30, 2006 was primarily the result of increases in salaries and wages and the use of third party contractors of \$144 and a \$25 increase in facilities cost allocation, partially offset by a decrease in the utilization of customer support and consulting personnel on internal R&D projects of \$25. The increase in R&D expense for the nine months ended September 30, 2007 as compared to the nine months ended September 30, 2006 was primarily the result of increases in headcount, salaries, and the use of third party contractors totaling \$421, an increase in facilities cost allocation of \$41, partially offset by a decrease in the utilization of customer support and consulting personnel on internal R&D projects of \$136. We expect our development efforts to continue at a similar level during the remainder of 2007 and expect our R&D expense to increase in absolute dollars but not as a percentage of revenue.

General and administrative ( G&A ) expense consists primarily of salaries, benefits, and other related costs including travel and facility expenses for finance, human resource, legal and executive personnel, legal and accounting professional services, provision for bad debts and director and officer insurance. The increase in G&A for the three months ended September 30, 2007 as compared to the three months ended September 30, 2006 is primarily due to increases in salaries, wages and benefits of \$63, and an increase in professional fees primarily related to Sarbanes-Oxley Regulations of \$69. The increase in G&A for the nine months ended September 30, 2007 as compared to the nine months ended September 30, 2006 is primarily due to increases in salaries, wages and benefits of \$174, and an increase in professional fees primarily related to Sarbanes Oxley Regulations of \$104. We expect G&A expense to continue to increase during the remainder of 2007 in absolute dollars but not as a percentage of sales, as we increase the G&A infrastructure and incur additional professional services costs for expenses related to the Sarbanes-Oxley Act of 2002.

**Table of Contents****Other Income, Net:**

|                                | Three Months Ended September 30, |              |              |              |                |                |
|--------------------------------|----------------------------------|--------------|--------------|--------------|----------------|----------------|
|                                | 2007                             | % of Revenue | 2006         | % of Revenue | Change Dollars | Change Percent |
| Legal fee reimbursement        | \$                               | %            | \$           | %            | \$             | %              |
| Interest and other income, net | 156                              | 2.7          | 93           | 1.8          | 63             | 67.7           |
| <b>Total Other Income</b>      | <b>\$ 156</b>                    | <b>2.7%</b>  | <b>\$ 93</b> | <b>1.8%</b>  | <b>\$ 63</b>   | <b>67.7%</b>   |

|                                | Nine Months Ended September 30, |              |               |              |                 |                |
|--------------------------------|---------------------------------|--------------|---------------|--------------|-----------------|----------------|
|                                | 2007                            | % of Revenue | 2006          | % of Revenue | Change Dollars  | Change Percent |
| Legal fee reimbursement        | \$                              | %            | \$ 464        | 3.2%         | \$ (464)        | %              |
| Interest and other income, net | 424                             | 2.4          | 154           | 1.1          | 270             | 173.5          |
| <b>Total Other Income</b>      | <b>\$ 424</b>                   | <b>2.4%</b>  | <b>\$ 618</b> | <b>4.2%</b>  | <b>\$ (194)</b> | <b>(31.4)%</b> |

Other income includes interest income earned on cash and money market instruments net of interest expense. Net interest income has increased as compared to the same periods in the prior year due to both a higher rate of interest and an increase in the amount of cash and cash equivalents on hand and available for investment. The 2006 legal fee reimbursement resulted from the May 17, 2006 award to the Company of approximately \$464 by the U.S. District Court for the Northern District of Illinois in connection with the TrueDoc lawsuit. Monotype Imaging, Inc. and International Typeface Corporation agreed to pay the full amount of the award and dismiss their appeal if the Company agreed not to appeal the Court's award set forth in the Court's May 17, 2006 Order. The Company accepted the proposal, received full payment and the case was terminated.

**(Benefit From), Provision for Income Taxes:**

|                                                   | Three Months Ended September 30, |              |        |              |                |                |
|---------------------------------------------------|----------------------------------|--------------|--------|--------------|----------------|----------------|
|                                                   | 2007                             | % of Revenue | 2006   | % of Revenue | Change Dollars | Change Percent |
| (Benefit from) provision for income tax provision | \$ 11                            | 0.2%         | \$ (9) | (0.2)%       | \$ 20          | 222.2%         |

|                                    | Nine Months Ended September 30, |              |       |              |                |                |
|------------------------------------|---------------------------------|--------------|-------|--------------|----------------|----------------|
|                                    | 2007                            | % of Revenue | 2006  | % of Revenue | Change Dollars | Change Percent |
| Provision for income tax provision | \$ 21                           | 0.1%         | \$ 27 | 0.4%         | \$ (6)         | (22.2)%        |

Our tax provision for the three and nine months ended September 30, 2007 consisted of \$11 and \$21 of foreign withholding taxes respectively. The Company did not have a provision for U.S. Federal tax during these periods due to Net Operating Loss and Tax Credit carry forwards. The tax provision for the three and nine month periods ended September 30, 2006 included an \$(11) benefit in U.S. Federal income tax due to a refund of alternative minimum tax and \$23 expense for U.S. Federal alternative minimum tax and \$2 and \$4, respectively, of foreign withholding taxes. Foreign taxes vary with OEM license royalties from customers in countries who are party to tax conventions with the United States, including Korea and Poland.

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### **LIQUIDITY AND CAPITAL RESOURCES (in thousands, except share amounts)**

The Company has funded its operations primarily through the public sale of equity securities, cash flows from operations, cash received from the sale of our MediaBank and InterSep OPI product lines to Inso Providence Corporation in August of 1998, and cash received from the sale of our investment in DiamondSoft to Extensis in July of 2003. As of September 30, 2007, we had net working capital of \$14,039 versus \$9,359 at December 31, 2006, an increase of \$4,680 or 50%.

Our operating activities generated \$3,400 in cash during the nine months ended September 30, 2007 primarily due to our \$2,817 net income before adjustment for non-cash expenses and an increase in deferred revenue of \$244. Our operating activities generated \$3,285 in cash during the nine months ended September 30, 2006 primarily due to our \$2,604 net income before adjustment for non-cash expenses and an increase in deferred revenue of \$365. Our investing activities used cash of \$392 and \$175 for the nine months ended September 30, 2007 and 2006, respectively, for the purpose of acquiring additional property and equipment and intangible assets. Our financing activities provided cash of \$1,679 and \$1,245 from the exercise of stock options for the nine months ended September 30, 2007 and September 30, 2006, respectively.

We believe our current cash and cash equivalent balances will be sufficient to meet our operating and capital requirements for at least the next 12 months. There can be no assurance, however, that we will not require additional financing in the future. If we were required to obtain additional financing in the future, there can be no assurance that sources of capital would be available on terms favorable to us, if at all.

As of September 30, 2007, we had no material commitments for capital expenditures. From time to time, we evaluate potential acquisitions of products, businesses and technologies that may complement or expand our business. Any such transactions consummated may use a portion of our working capital or require the issuance of equity or debt.

We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is primarily based on a dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense is recorded under our cost of license revenue on our consolidated Statement of Operations.

We enter into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally business partners or customers, in connection with any U.S. patent, or any copyright or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal, but we can provide no assurance that payments will not be required under these agreements in the future.

### **RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157) which defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in generally accepted accounting principles ("GAAP") and expands disclosure related to the use of fair value measures in financial statements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The adoption of SFAS 157 is not expected to have a material impact on our financial position, results of operations or cash flows.

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In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently assessing the provisions of SFAS 159.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments.**

As of September 30, 2007, we did not participate in any derivative financial instruments or other financial and commodity instruments for which fair value disclosure would be required under SFAS No. 107. All of our investments are short-term money market accounts and bank deposits that are carried on our books at fair market value. Accordingly, we have no quantitative information concerning the market risk of participating in such investments.

#### **Primary Market Risk Exposures**

Our primary market risk exposures are in the areas of interest rate risk and foreign currency exchange rate risk. Our investment portfolio of cash equivalent and short-term investments is subject to interest rate fluctuations, but we believe this risk is immaterial due to the short-term nature of these investments. Our exposure to currency exchange rate fluctuations has been and is expected to continue to be modest due to the fact that the operations of our international subsidiary when it is active are almost exclusively conducted in the local currency. Our international subsidiary is currently inactive and the impact of currency exchange rate movements on inter-company transactions was immaterial for the three and nine month periods ended September 30, 2007. International subsidiary operations, if resumed, will be translated into U.S. dollars and consolidated for reporting purposes. Currently, we do not engage in foreign currency hedging activities.

### **ITEM 4. CONTROLS AND PROCEDURES**

Based on the evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of September 30, 2007, each of Anna Chagnon, Principal Executive Officer, and James Dore, Principal Financial Officer, of the Company, have concluded that our disclosure controls and procedures were (1) effective to ensure that information required to be disclosed by us in this quarterly report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (2) designed to ensure that information required to be disclosed was accumulated and communicated to the Company's Principal Executive Officer and Principal Financial Officer to allow timely decisions regarding required disclosure.

There were no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2007 that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

Our management, including our Principal Executive Officer and Principal Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. Our Principal Executive Officer and Principal Financial Officer have determined that the disclosure controls and procedures are effective at the reasonable assurance level.

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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

From time to time we are subject to legal proceedings and claims in the ordinary course of business, including claims of infringement of third-party patents and other intellectual property rights, commercial, employment and other matters. In accordance with GAAP, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. This provision is reviewed at least quarterly. As of September 30, 2007 no liability was recorded. Litigation is inherently unpredictable and it is possible that our financial position, cash flows, or results of operations could be materially affected in any particular period by the resolution of any such contingencies or the costs involved in seeking the resolution of any such contingencies.

**ITEM 1A. RISK FACTORS**

There have not been any material changes in the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 and filed with the SEC on March 30, 2007.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

- (a) Instruments defining the rights of the holders of any class of our registered securities have not been materially modified during the three months ended September 30, 2007.
- (b) Rights evidenced by any class of our registered securities have not been materially limited or qualified by the issuance or modification of any other class of securities during the three months ended September 30, 2007.
- (c) There were no unregistered securities sold by us during the three months ended September 30, 2007.
- (d) There were no repurchases by us of our equity securities during the three months ended September 30, 2007.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**  
**NONE**

**ITEM 5. OTHER INFORMATION**

- (a) Consistent with Section 10A(i)(2) of the Securities Exchange Act of 1934, as amended, as added by Section 202 of the Sarbanes-Oxley Act of 2002, the Company is responsible for listing the non-audit services approved during any reporting period by its Audit Committee to

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be performed by PricewaterhouseCoopers LLP, the Company's external auditor. All non-audit services are pre-approved by the Audit Committee or the Audit Committee's Chairman pursuant to delegated authority by the Audit Committee. There were no such matters brought before the Audit Committee during the three months ended September 30, 2007.

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- (b) During the three months ended September 30, 2007, there were no changes made to the procedures by which security holders may recommend nominees to the Company's Board of Directors.

**ITEM 6. EXHIBITS**

- (a) Exhibits

**CERTIFICATIONS**

- 31.1 Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**PART II SIGNATURES**

**SIGNATURES**

Pursuant to the requirements 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.

**BITSTREAM INC.**

(Registrant)

| <b>SIGNATURE</b>                       | <b>TITLE</b>                                                                    | <b>DATE</b>       |
|----------------------------------------|---------------------------------------------------------------------------------|-------------------|
| /s/ Anna M. Chagnon<br>Anna M. Chagnon | President and Chief Executive Officer<br><br>(Principal Executive Officer)      | November 14, 2007 |
| /s/ James P. Dore<br>James P. Dore     | Vice President and Chief Financial Officer<br><br>(Principal Financial Officer) | November 14, 2007 |