BITSTREAM INC
Form 10-Q
November 15, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

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

BITSTREAM INC.

(Exact name of registrant as specified in its charter)

Delaware	**04-2744890**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

500 Nickerson Road, Marlborough, Massachusetts 01752-4695

(Address of principal executive offices and zip code)

(617) 497-6222

(Registrant s telephone number, including area code)

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 Exchange 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 x No ¨

Indicate by checkmark whether the registrant has submitted electronically and posted on its 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). (the Registrant is not yet required to submit Interactive Data) Yes ¨ No ¨

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

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

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

On November 10, 2010, there were 10,190,637 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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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

BITSTREAM INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS, EXCEPT PER-SHARE AMOUNTS)

(Unaudited)

	September 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,677	$ 17,915
Accounts receivable, net	1,188	1,689
Prepaid expenses and other current assets	641	802
Short-term investments	114	114
Total current assets	6,620	20,520
Property and equipment, net	622	643
Other long-term assets:		
Long-term investments	7,954	136
Goodwill	3,537	727
Intangible assets, net	3,561	78
Total other long-term assets	15,052	941
Total assets	$ 22,294	$ 22,104
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,114	$ 1,091
Accrued payroll and other compensation	954	261
Other accrued expenses	844	808
Deferred revenue	1,867	1,762
Total current liabilities	4,779	3,922
Long-term deferred revenue	64	
Long-term deferred rent	533	536
Total long-term liabilities	597	536
Total liabilities	5,376	4,458

Commitments and contingencies (Note 7)		
Stockholders equity:		
Preferred stock, $0.01 par value: 6,000 shares authorized; no shares issued or outstanding at September 30, 2010 and December 31, 2009		
Common stock, $0.01 par value:		
Class A: 30,000 shares authorized; 10,196 and 10,120 shares issued and 10,191 and 9,953 shares outstanding at September 30, 2010 and December 31, 2009, respectively	102	101
Class B: 500 shares authorized; no shares issued or outstanding at September 30, 2010 and December 31, 2009		
Additional paid-in capital	35,191	35,043
Accumulated deficit	(18,731)	(16,474)
Treasury stock, at cost; 5 and 167 shares at September 30, 2010 and December 31, 2009, respectively	(29)	(994)
Accumulated other comprehensive income (loss)	385	(30)
Total stockholders equity	16,918	17,646
Total liabilities and stockholders equity	$ 22,294	$ 22,104

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)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Revenue:				
Software licenses	$ 4,739	$ 4,512	$ 13,075	$ 12,361
Services	1,243	1,148	3,550	3,549
Total revenue	5,982	5,660	16,625	15,910
Cost of revenue:				
Software licenses	2,346	1,779	6,644	4,946
Services	518	500	1,472	1,622
Total cost of revenue	2,864	2,279	8,116	6,568
Gross profit	3,118	3,381	8,509	9,342
Operating expenses:				
Marketing and selling	945	871	2,647	2,778
Research and development	2,057	1,234	5,076	3,641
General and administrative	1,207	740	2,994	2,195
Total operating expenses	4,209	2,845	10,717	8,614
Operating income (loss)	(1,091)	536	(2,208)	728
Interest and other income, net	45	18	109	53
Income (loss) before provision for income taxes	(1,046)	554	(2,099)	781
Provision for income taxes	128	35	158	96
Net income (loss)	$ (1,174)	$ 519	$ (2,257)	$ 685
Basic net income (loss) per share	$ (0.12)	$ 0.05	$ (0.23)	$ 0.07
Diluted net income (loss) per share	$ (0.12)	$ 0.05	$ (0.23)	$ 0.07
Basic weighted average shares outstanding	9,921	9,799	9,878	9,770
Diluted weighted average shares outstanding	9,921	10,248	9,878	10,179

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)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ (2,257)	$ 685
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Stock-based compensation	778	616
Depreciation	213	208
Loss on disposal of property and equipment	1	5
Amortization of long-lived intangible assets	149	21
Amortization of purchased premium on marketable securities	59	
Unrealized foreign currency loss	30	
Changes in operating assets and liabilities, net of the effects of the acquisition:		
Accounts receivable	501	428
Prepaid expenses and other assets	245	(410)
Premium on long-term investments in marketable securities	(948)	
Accounts payable	23	647
Accrued payroll and other compensation	693	(677)
Other accrued expenses	36	(26)
Deferred revenue	169	(372)
Deferred rent	(3)	407
Net cash provided by (used in) operating activities	(311)	1,532
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(113)	(417)
Acquisition of Press-sense Ltd.	(6,528)	
Additions to intangible assets	(22)	(8)
Purchase of investments in marketable securities	(8,050)	
Proceeds from sale of marketable securities	1,450	
Net cash used in investing activities	(13,263)	(425)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from exercises of stock options	336	413
Net cash provided by financing activities	336	413
Effect of foreign currency exchange rates on cash and cash equivalents		(9)
Net (decrease) increase in cash and cash equivalents	(13,238)	1,511
Cash and cash equivalents, beginning of period	17,915	16,162

Cash and cash equivalents, end of period	$ 4,677	$ 17,673

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

All references to Bitstream, we, us, our, or Company refer to Bitstream Inc. and its subsidiaries. Except as otherwise noted, all reported doll amounts are in thousands.

(1) Operations and Significant Accounting Policies

The Company is a software development company focused on bringing unique software products to a wide variety of markets. Our core software products include award-winning fonts and font rendering technologies, mobile browsing and messaging technologies, variable data publishing and web-to-print technologies, and multi-channel communications technologies.

The Company is 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. The Company has also experienced net losses in the current year, as well as prior years, and as of September 30, 2010 has an accumulated deficit of approximately $18.7 million. For a complete discussion of our business risks, see the Risk Factors under Part I, Item 1A. beginning on page 18 of the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

(a) Use of Estimates

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. Significant estimates in these financial statements include revenue recognition, valuation of intangible assets, share-based compensation, income taxes and the valuation of deferred tax assets, and the allowance for doubtful accounts receivable. Actual results may differ from these estimates.

(b) Basis of Presentation

Our unaudited condensed consolidated financial statements presented herein 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 as of December 31, 2009 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, 2009 included in our Annual Report on Form 10-K, which was filed with the SEC on March 31, 2010. The condensed consolidated balance sheet as of September 30, 2010, the condensed consolidated statements of operations for the three and nine months ended September 30, 2010 and 2009, and the condensed consolidated statement of cash flows for the nine months ended September 30, 2010 and 2009, 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, 2010 may not necessarily be indicative of the results to be expected for the year ending December 31, 2010.

Certain prior year amounts have been reclassified to conform with the current year s presentation. The Company evaluated subsequent events through November 15, 2010 to determine whether or not any such events required disclosure in this Form 10-Q, and determined that no such subsequent event has occurred.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(c) Property and Equipment

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

	September 30, 2010	December 31, 2009
Equipment and computer software	$ 1,992	$ 1,914
Purchased software	437	425
Furniture and fixtures	612	586
Leasehold improvements	100	88
	3,141	3,013
Less Accumulated depreciation and amortization	2,519	2,370
Property and equipment, net	$ 622	$ 643

Depreciation expense for the three months ended September 30, 2010 and 2009 was $80 and $66, respectively. Depreciation expense for the nine months ended September 30, 2010 and 2009 was $213 and $208, respectively.

During the three and nine months ended September 30, 2010, we disposed of $52 and $65 of property and equipment with accumulated depreciation of $52 and $64 resulting in a loss on disposal of $1 for the nine months ended September 30, 2010. The assets were no longer in service.

(d) Off-Balance Sheet Risk and Concentration of Credit Risk

Financial instruments that potentially expose the Company to concentrations of credit risk consist primarily of cash and cash equivalents, investments in marketable securities, and trade accounts receivable. The Company places a majority of its cash and cash equivalents in one highly-rated financial institution and holds its marketable securities in a custodial account at another highly-rated financial institution. The Company had not experienced significant losses related to receivables from any individual customers or groups of customers in any specific industry or by geographic area prior to January 2009. During 2009, we established reserves for certain customers affected by the economic downturn and increased our allowance for doubtful accounts from $32 at December 31, 2008 to $283 at December 31, 2009. During the three and nine month periods ended September 30, 2010 the Company wrote-off approximately $1 and $230, respectively, of the reserved accounts. The Company evaluated its accounts receivable balance at September 30, 2010 and determined that its allowance for bad debts of $25 was adequate. 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, 2010, two customers accounted for 51% and 15% of our accounts receivable, respectively. At December 31, 2009, two customers accounted for 27% and 24% of our accounts receivable, respectively. We do not have any off-balance sheet risks as of September 30, 2010 or December 31, 2009. One customer accounted for 10% of our revenue for the three month period ended September 30, 2010. For the three months ended September 30, 2010 and for the three and nine month periods ended September 30, 2009, no single customer accounted for 10% or more of our revenue.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(e) Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income (loss) and adjustments to stockholders equity for unrealized gains from investments in marketable securities classified as available-for-sale. For purposes of comprehensive income (loss) disclosures, the Company does not record tax provisions or benefits for unrealized gains or losses on investments in marketable securities as we have recorded a full valuation allowance against our deferred tax assets and are not currently recording a tax liability.

The components of comprehensive income (loss) are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Net income (loss)	$ (1,174)	$ 519	$ (2,257)	$ 685
Unrealized gain on investments in marketable securities, net	192		385	
Foreign currency adjustment, net of tax of $0		(2)		(11)
Total comprehensive income (loss)	$ (982)	$ 517	$ (1,872)	$ 674

Accumulated other comprehensive income (loss) consisted of the following:

	September 30, 2010	December 31, 2009
Unrealized gain on investments in marketable securities, net	$ 385	$
Foreign currency translation		(30)
Other comprehensive income (loss)	$ 385	$ (30)

(f) Recently Issued Accounting Standards

The Company reviews and evaluates recent pronouncements that have had or may have a significant effect on our financial statements. The Company has not included a discussion of recent pronouncements below as none are anticipated to have an impact on or are unrelated to our financial condition, results of operations, or disclosures.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(g) Fair Value of Financial Instruments

The fair value measurement rules establish a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Under authoritative guidance fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. This guidance also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs, where available, and minimize the use of unobservable inputs when measuring fair value.

This guidance describes three levels of inputs that may be used to measure fair value:

Level 1	Quoted prices in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset and liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
Level 2	Observable inputs other than Level 1 prices, 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	Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

At December 31, 2009, the Company s financial assets and liabilities that were measured at fair value on a recurring basis included money market funds of $10, short-term investments in certificates of deposit of $114, and a restricted investment long-term of $136, which were Level 1 financial assets. As required by authoritative guidance, assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The Company 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. The adoption of this guidance for non-financial assets and liabilities did not have a material impact on our consolidated financial position, results of operations or cash flows.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Assets and liabilities of the Company measured at fair value on a recurring basis are summarized as follows as of September 30, 2010:

		Fair Value Measurements at Reporting Date Using		
Description	**September 30, 2010**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets				
Money market funds	$ 642	$ 642	$	$
Certificates of deposit	250	250		
Government bonds	1,230	1,230		
Corporate bonds	6,588	6,588		
Total assets	$ 8,710	$ 8,710	$	$

Cash equivalents are short-term, highly liquid investments with original maturity dates of three months or less at the date of acquisition. Cash equivalents are carried at cost plus accrued interest, which approximates fair value. The Company s investments in marketable securities, corporate and government bonds, are classified as available-for-sale and are recorded at fair value with any unrealized gain or loss recorded as an element of stockholders equity. Purchased interest is included in interest receivable and reported as other current assets in our condensed consolidated balance sheet. The amortized cost of debt securities in this category is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in interest and other income, net of expense. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest and other income, net of expense. The fair value of investments in marketable securities is determined based on quoted market prices at the reporting date for those instruments.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(h) Foreign Currency Translation and Transactions

Transaction gains (losses) for the three months ended September 30, 2010 and 2009 were $(25) and $18, respectively, and for the nine months ended September 30, 2010 and 2009 were $(29) and $45, respectively. Transaction gains were recorded as interest and other income, net in the condensed consolidated statements of operations.

(2) Cash, Cash Equivalents and Investments in Marketable Securities

Our investments in marketable securities, corporate and government bonds, are classified as available-for-sale and are recorded at fair value with any unrealized gain or loss recorded as an element of stockholders equity. Purchased interest is included in interest receivable and reported as other current assets in our condensed consolidated balance sheet. The amortized cost of debt securities in this category is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in interest and other income, net. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest and other income, net. As of September 30, 2010 and December 31, 2009, aggregate cash and cash equivalents and investments in marketable securities consisted of:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
September 30, 2010:				
Cash and cash equivalents	$ 4,677	$	$	$ 4,677
Government bonds	1,180	50		1,230
Corporate bonds	6,253	339	(4)	6,588
Short-term investments certificate of deposit	114			114
Restricted investment long-term	136			136
Total	$ 12,360	$ 389	$ (4)	$ 12,745
December 31, 2009:				
Cash and cash equivalents	$ 17,915	$	$	$ 17,915
Short-term investments certificate of deposit	114			114
Restricted investment long-term	136			136
Total	$ 18,165	$	$	$ 18,165

BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(3) Acquisition

On June 3, 2010, the Company completed the acquisition of certain of the assets of Press-sense Ltd. (Press-sense) pursuant to terms of a Purchase and Sale Agreement dated May 31, 2010 by and among the Company, Bitstream Israel Ltd., a wholly-owned subsidiary of the Company organized under the Laws of the State of Israel and the court appointed Special Manager of Press-sense Ltd., an Israeli company in temporary liquidation under the supervision of the District Court of Haifa. The purchase price of $6,528, including $28 of VAT, was paid in cash. Assets purchased include all Press-sense software and know-how and related intellectual property rights (both source code and object code), some fixed and tangible assets, and all trademarks, transferable licenses and customer data. No liabilities were acquired in the transaction.

The results of operations of the Press-sense assets have been included in the condensed consolidated financial statements since June 3, 2010. Press-sense was a developer of print industry business flow automation systems. The Press-sense business will complement and expand Bitstream s Pageflex product line of enterprise brand management and web-to-print solutions to create one of the most robust end-to-end offerings of business management tools available in the marketing and print industries. By fully automating the creation, production, and back-office processes for document orders, Bitstream will provide the tools to enable its customers to maximize production efficiency, monitor and reduce costs, and increase profits.

The acquisition was accounted for using the purchase method of accounting in accordance with appropriate standards. The allocation of the purchase price is preliminary and is subject to adjustment. The Company expects to finalize the purchase accounting in the period ending December 31, 2010. The following table summarizes the preliminary allocation of the purchase price of $6,528:

Total consideration cash paid	$ 6,528
Allocation of the purchase consideration	
VAT tax receivable	$ 28
Fixed assets	80
Identifiable intangible assets	3,610
Goodwill	2,810
Total assets acquired	$ 6,528

Goodwill was recognized for the excess purchase price over the fair value of the assets acquired. Goodwill is primarily attributable to the expected growth from synergies related to the integration of Press-sense assets acquired with the Company s Pageflex publishing software. Goodwill from the acquisition of Press-sense Ltd. assets will be included within the Company s one reporting unit and will be included in the Company s enterprise-level annual review for impairment. Goodwill is deductible for tax purposes.

The following table reflects the fair value of the acquired identifiable intangible assets and related estimates of useful lives:

	Fair Value	Useful life (Years)
Developed product technology	$ 1,410	7.5
Customer relationships	2,200	11.5

Total	$	3,610

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the pro forma results of the historical condensed consolidated statements of operations of the Company and Press-sense Ltd. for the three and nine month periods ended September 30, 2010 and September 30, 2009, giving effect to the merger as if it occurred on January 1, 2010 and 2009:

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Pro forma revenue	$ 5,982	$ 7,987	$ 18,752	$ 21,395
Pro forma net income (loss)	$ (1,174)	$ 11	$ (3,770)	$ (2,745)
Pro forma loss per share:				
Basic and Diluted	$ (0.12)	$	$ (0.38)	$ (0.28)
Pro forma shares outstanding:				
Basic	9,921	9,799	9,878	9,770
Diluted	9,921	10,248	9,878	9,770

The pro forma net loss and loss per share for each period presented primarily includes adjustments for amortization of intangibles, depreciation, interest income, and income taxes. This pro forma information does not purport to indicate the results that would have actually been obtained had the acquisition been completed on the assumed date, or which may be realized in the future.

(4) Goodwill & Other Intangible Assets

Goodwill

Goodwill resulted from the acquisitions of Type Solutions, Inc. and Alaras Corporation, as well as the purchase of certain assets from Press-sense Ltd. on June 3, 2010. Goodwill was $3,537 and $727 at September 30, 2010 and December 31, 2009, respectively. The change in the carrying amount of goodwill for the nine months ended September 30, 2010 is as follows:

Balance January 1, 2010	$ 727
Goodwill related to the purchase of assets from Press-sense Ltd.	2,810
Balance September 30, 2010	$ 3,537

The Company follows the accounting and reporting requirements for goodwill and other intangible assets as required by authoritative standards. Under these standards, goodwill is not amortized, but is required to be reviewed annually for impairment, or more frequently if impairment indicators arise. The Company has determined that it does not have separate reporting units and thus goodwill is tested for impairment based upon an enterprise wide valuation. The Company has not recorded any impairment charges related to goodwill since the time of the change to the authoritative guidance which called for goodwill to be reviewed for impairment based on the results of impairment tests rather than amortized.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other Intangible Assets

The carrying amounts of other intangible assets were $3,561 and $78 as of September 30, 2010 and December 31, 2009, respectively. Intangible assets acquired in a business combination are recorded under the purchase method of accounting at their estimated fair values at the date of acquisition. The Company amortizes other intangible assets over their estimated useful lives on a straight-line basis. Marketing-related intangibles have useful lives of five to eight years. Technology-based intangible assets have useful lives of five to twelve years. The weighted average useful life of other intangible assets is 9 years. The components of the Company s amortized intangible assets follow:

	September 30, 2010		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Marketing-related	$ 2,292	$ (146)	$ 2,146
Technology-based	2,048	(633)	1,415
Total	$ 4,340	$ (779)	$ 3,561

	December 31, 2009		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Marketing-related	$ 85	$ (81)	$ 4
Technology-based	623	(549)	74
Total	$ 708	$ (630)	$ 78

Amortization expense for marketing-related intangible assets included in marketing and selling expense for the three months ended September 30, 2010 and 2009 was $48 and $0, respectively. Amortization expense for technology-related intangible assets included as cost of revenue for the three months ended September 30, 2010 and 2009 was $47 and $0, respectively. Amortization expense for intangible assets included as general and administrative expense for the three months ended September 30, 2010 and 2009 was $7. Amortization expense for marketing-related intangible assets included in marketing and selling expense for the nine months ended September 30, 2010 and 2009 was $64 and $0, respectively. Amortization expense for technology related intangible assets included as cost of revenue for the nine months ended September 30, 2010 and 2009 was $63 and $0, respectively. Amortization expense for intangible assets included in general and administrative expense for the nine months ended September 30, 2010 and 2009 was $22 and $21, respectively. Estimated amortization for succeeding years is as follows:

Estimated Amortization Expense:	
2010, remaining	$ 198
2011	509
2012	502
2013	494
2014	489
Thereafter	1,369

Total	$ 3,561

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(5) Income Per Share

Basic income or loss per share is determined by dividing net income or loss 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, warrants, and restricted shares, based on the treasury stock method. A reconciliation of basic and diluted weighted average shares outstanding for basic and diluted earnings per share is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Basic weighted average shares outstanding	9,921	9,799	9,878	9,770
Dilutive effect of options		435		401
Dilutive effect of unvested restricted shares		14		8
Shares used to compute diluted net income per share	9,921	10,248	9,878	10,179

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. As a result there is no difference between the Company s basic and diluted loss per share for the three and nine month periods ended September 30, 2010. If the Company had reported a profit for the three and nine month periods ended September 30, 2010, the potential common shares would have increased the weighted average shares outstanding by 549 and 631 shares, respectively. In addition, there were unvested restricted shares and options outstanding to purchase 636 and 490 shares, respectively, for the three and nine month periods ended September 30, 2010 and 439 and 698 shares for the three and nine month periods ended September 30, 2009, respectively, that were not included in the potential common share computations because their exercise prices were greater than the market price of the Company s common stock. These common stock equivalents are antidilutive even when a profit is reported in the numerator.

(6) Equity-Based Compensation Expense

The Company accounts for stock-based compensation in accordance with authoritative guidance and has elected the modified prospective method, under which, stock based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period.

The Company currently estimates the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the award, the expected option term, the expected volatility of its stock over the option s expected term, the risk-free interest rate over the option s expected term, and its expected annual dividend yield. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. The Company believes 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.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the weighted average assumptions we utilized for grants of share-based awards during the three and nine months ended September 30, 2010 and 2009:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Risk-free interest rates	1.0% 2.0%	2.8%	1.0% 2.0%	2.8%
Expected dividend yield	None	None	None	None
Expected term	6.2 Years	6.07 Years	6.2 Years	6.07 Years
Expected volatility	65.9%	73.7%	65.9%	73.7%

All options granted have a contractual ten-year term. All options granted prior to January 1, 2006 vested in equal installments on the first, second, and third year anniversaries over a three year period of continuous employee service. All options granted subsequent to January 1, 2006 vest in equal installments on the first, second, third, and fourth year anniversaries over a four year period of continuous employee service. All restricted stock awards made prior to January 1, 2010 vest in equal installments on the first, second, third, fourth and fifth year anniversaries over a five year period of continuous employee service. All restricted stock awards made subsequent to January 1, 2010 vest in 20 equal installments on the quarterly anniversaries from the date of grant over a five-year period. 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.

The Company s results for the three months ended September 30, 2010 and 2009 include $293 and $216, respectively, and for the nine months ended September 30, 2010 and 2009 include $778 and $616, of share-based compensation within the applicable expense classification where it reports the share-based award holders compensation expense.

The following table presents share-based compensation expense included in the Company s condensed consolidated statement of operations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Cost of revenue-software licenses	$ 1	$ 1	$ 3	$ 3
Cost of revenue-services	10	19	47	56
Marketing and selling	5	10	30	36
Research and development	91	87	281	248
General and administrative	186	99	417	273
	$ 293	$ 216	$ 778	$ 616

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(7) Commitments and Contingencies,

Lease commitments

The Company conducts its operations in leased facilities. In June 2009, the Company entered into a ten-year lease agreement for 27,000 square feet of office space with the right of first refusal on an additional 4,000 square feet in a building located in Marlborough, Massachusetts. This lease agreement commenced September 1, 2009 and obligates 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. The lease payments began after three (3) rent-free months and increase by approximately 2% per annum. The remaining commitment under the lease at September 30, 2010 is approximately $4,979. The Company records rent expense on a straight-line basis, taking into consideration the free rent period, the tenant allowance received at the outset of the lease, and annual incremental increases to the lease payments. The Company s current lease agreement also requires it to maintain a Letter of Credit in the amount of $136 through October 31, 2019, which the Company collateralized with a certificate of deposit classified as a long-term restricted asset on the condensed consolidated balance sheet.

In July 2008, Bitstream India Pvt. Ltd., our wholly-owned subsidiary, entered into a 33-month lease agreement in Nodia, India. This lease agreement commenced May 1, 2008 and obligates the Company to make monthly payments including service taxes. The remaining commitment at September 30, 2010 is approximately $28.

Royalties

The Company has 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 the condensed consolidated statement of operations.

Indemnification Agreements

The Company enters into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees 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, copyright or other intellectual property infringement claim by any third party with respect to its 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. The Company has 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, the Company is 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, and claims involving commercial, employment and other matters. In accordance with generally accepted accounting principles, the Company makes 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, 2010, there are no material pending legal proceedings to which we are a party, and no liability was recorded. Litigation is inherently unpredictable and it is possible that the Company s 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.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(8) Income Taxes

The Company accounts for income taxes under the liability method in accordance with authoritative guidance, under which a deferred tax asset or liability is determined based on the difference between the financial statement and the tax basis of assets and liabilities, as measured by enacted tax rates in effect when these differences are expected to reverse.

The following is a summary of the components of the provision for and (benefit from) income taxes:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Current:				
Federal	$ 19	$	$ 25	$
State	(24)	15	(24)	67
Foreign	133	20	157	29
Total	$ 128	$ 35	$ 158	$ 96

Foreign taxes include foreign withholding taxes from OEM license royalties from customers in countries who are a party to tax conventions with the United States including Korea, Israel and Poland, as well as foreign taxes paid by Bitstream India Pvt. Ltd., our subsidiary, in India and by Bitstream Israel Ltd. our subsidiary in Israel. Federal income tax is related to the deferred tax liability from the amortization of Goodwill for tax purposes. Federal and state tax provisions for the three and nine month periods ended September 30, 2009 included amounts in relation to the Company s income generated in the U.S., reduced by previously unused net operating loss (NOL) carry forwards and tax credits that were recorded on the balance sheet with a full valuation allowance.

At December 31, 2009, the Company had U.S. federal and state net operating loss (NOL) carryforwards of $11,332 and $289, respectively, of which the benefit of approximately $8,272 and $289, respectively, when realized, will be recorded as a credit to additional paid-in capital. The Company s NOL carryforwards begin to expire in 2020 for federal purposes. At December 31, 2009, the Company also had U.S. federal and state research and development credit (R&D Credit) carryforwards of $1,011 and $366, respectively. These R&D credit carryforwards begin to expire in 2010 for federal purposes and 2016 for state purposes. As of December 31, 2009, we had foreign tax credit carryforwards of $490. These foreign tax credit carryforwards begin to expire in 2012.

The Company continued to provide a full valuation allowance for its net deferred tax assets at September 30, 2010, as it believes it is more likely than not that the future tax benefits from accumulated net operating losses and deferred taxes will not be realized. The Company continues to assess the need for the valuation allowance at each balance sheet date based on all available evidence. However, it is possible that the more likely than not criterion could be met in future periods, which could result in the reversal of a significant portion or all of the valuation allowance, which, at that time, would be recorded as a tax benefit in the condensed consolidated statement of operations.

BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In June 2006, the FASB issued authoritative guidance clarifying the criteria that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in a company s financial statements. The Company adopted this guidance on January 1, 2007, the implementation of which did not have a material impact on the Company s consolidated financial statements, results of operations or cash flows. At the adoption date of January 1, 2007, and also at December 31, 2009 and September 30, 2010, the Company had no unrecognized tax benefits.

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. As of September 30, 2010, the Company had no accrued interest or penalties related to uncertain tax positions. The Company s 2005 through 2009 tax years remain open to examination by the major taxing jurisdictions to which it is subject. The Company has determined that it is more likely than not that the deferred tax assets will not be realized, therefore, a valuation allowance has reduced the deferred tax assets to zero.

(9) Geographical Reporting

The Company reports revenue and income under one reportable segment. Company management assesses operating results on an aggregate basis to make decisions about the allocation of resources. Revenue by geography is based on the billing address of the customer. The following tables set forth revenue and long-lived assets by geographic area:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
*Revenue:				
United States	$ 4,616	$ 4,687	$ 13,628	$ 12,987
United Kingdom (UK)	416	345	1,251	899
Korea	625	121	688	179
Other (Countries less than 5% individually, by Region)				
Europe, excluding UK	131	212	532	705
Asia, excluding Korea	9	55	92	468
Other, including Canada	185	240	434	672
Total revenue	$ 5,982	$ 5,660	$ 16,625	$ 15,910

* 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.

Long-lived tangible assets by geographic area are as follows:

	September 30, 2010	December 31, 2009
United States	$ 534	$ 626
Israel	62	
India	26	17
Total	$ 622	$ 643

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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. All references to Bitstream, we, us, our, or Company refer to Bitstream Inc. and its subsidiaries. Except as otherwise noted, all reported dollar amounts are in thousands.

OVERVIEW

The Company is a software development company focused on bringing unique software products to a wide variety of markets. Our core software products include award-winning fonts and font rendering technologies; mobile browsing technologies; and variable data publishing; Web-to-print and multi-channel communications technologies.

Mobile Browsing Technologies. BOLT provides a consistent, full desktop-style browsing experience on almost any handset. Based upon the Company s ThunderHawk technology, BOLT was released into private beta in January 2009, and through March 2010, BOLT has been installed over 5 million times by mobile phone users looking for a better mobile browsing experience. The BOLT mobile browser offers faithful rendering of Web pages and it is the only browser for mobile phones of all types to support streaming video from popular media sharing sites such as YouTube and MySpace. Compatible with most handsets that support the J2ME or BREW/BMP operating systems, BOLT s advanced features include W3C based widget support, direct Twitter integration, six levels of magnification, international localization, copy/paste, FOTA updates, and additional usability features such as auto-complete url, save page, secure browsing, patented split-screen minimap, password manager, rss subscriptions, automatic socket support, history and keypad shortcuts. BOLT is a WebKit based cloud-computing mobile browser. This cloud computing architecture is the key to BOLT s capabilities. Web pages are first loaded by the BOLT servers, then transcoded and sent to the BOLT mobile browser client on handsets. This client/server approach maintains the integrity of Web page layouts, reduces packet consumption on data networks, dramatically improves page load speeds, and enables advanced features such as video streaming.

Fonts and Font Rendering Technologies. Bitstream is a leading developer of font technology solutions that enable developers to display high-quality text in any language for any device or application. We work with partners from around the world to provide complete text composition and font rendering solutions for consumer electronics devices, mobile handsets, set-top boxes, digital TVs, printers, graphics and software applications, and embedded systems. Our solutions include Bitstream Panorama for text composition and Font Fusion® for font rendering. Bitstream font technology supports all international languages. With our technology, developers can render any scalable industry-standard and compact font format. Developers rely on Bitstream for complete font solutions, including a certified Simplified Mainland Chinese font, MobileFonts , the Tiresias Screenfont, the Closed Captioned TV (CCTV) Font Set, the TV Font Pack, delta-hinted screen fonts, and compact stroke-based Asian fonts. Bitstream also delivers high-quality font solutions for developers, ad agencies, graphic designers, desktop publishers, corporations, small businesses, and home office users. Our world-renowned library includes over 1,000 high-quality fonts in OpenType, TrueType, and PostScript Type 1 formats for Windows, Macintosh, Unix, and Linux. We also sell our fonts and fonts from other foundries and designers on MyFonts.com SM, a showcase of the world s fonts available from one easy-to-use website. MyFonts.com provides the largest collection of fonts ever assembled for on-line delivery, and offers easy ways to find and purchase fonts on-line. MyFonts also offers unique typographic resources for research and reference, including WhatTheFont SM, a unique font identifier that accepts image files of fonts uploaded by users, analyzes the images, and then displays the fonts on the MyFonts.com site that most closely match the font shapes captured in the image. WhatTheFont is also available as an iPhone application.

Variable Data Publishing, Web-to-print, and Multi-channel Communications Technologies. The Pageflex® product line from Bitstream enables companies across the globe to communicate their marketing messages more easily and effectively. It is the technology of choice for brand management, web-to-print applications, and sophisticated personalized communications based on customer information. We pioneered flexible variable data software in 1997

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and have been a technology innovator in the document customization arena ever since. The platform produces rich, creative, award-winning document designs that look like they were given the individual attention of a graphic designer but were, in reality, created on-the-fly with Pageflex variable publishing technology. Print service providers, marketing service providers, corporate marketers, and publishers use Pageflex products to ensure design integrity and brand control while empowering local users to customize and personalize print collateral, email campaigns, and 1-to-1 marketing Web sites. Pageflex Persona is desktop software that produces personalized print and email documents using data from a database. Pageflex Studio ID is a plug-in to Adobe InDesign for producing personalized print pieces. Pageflex Storefront is a turnkey solution for producing web portals for document customization and online purchasing of print documents. Pageflex Server provides an enterprise solution for high-volume document customization driven by a database or requests from a web site. Pageflex Campaign Manager lets companies develop personal conversations with their customers in print, email, and online. And finally, Pageflex Chart works with these Pageflex products to add dynamic charts and graphs to print documents. Pageflex products enable companies worldwide to streamline their document production processes, communicate more personally with their customers, and control their brand and market messaging while enabling their remote employees, franchises, and consumers to use a self-serve model to order customized communications.

Business flow automation systems. On June 3, 2010, the Company completed the acquisition of certain of the assets of Press-sense Ltd. (Press-sense). Press-sense was a developer of print industry business flow automation systems. The Press-sense business will complement and expand Bitstream s Pageflex product line of enterprise brand management and web-to-print solutions to create one of the most robust end-to-end offerings of business management tools available in the marketing and print industries. By fully automating the creation, production, and back-office processes for document orders, Bitstream will provide the tools to enable its customers to maximize production efficiency, monitor and reduce costs, and increase profits.

CRITICAL ACCOUNTING POLICIES

The Company has identified the policies below as critical to its business operations and the understanding of its results of operations. The impact and any associated risks related to these policies on our business operations is discussed throughout this Management s Discussion and Analysis of Financial Condition and Results of Operations where such policies affect the Company s reported and expected financial results. Note that our preparation of this Quarterly Report on Form 10-Q requires us to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates.

Revenue Recognition

We derive revenue from the license of our software products, consulting, and support and maintenance services. We recognize revenue when persuasive evidence of an agreement exists, the product has been delivered or services have been provided, the fee is fixed or determinable, and collection of the fee is probable.

Multiple-element arrangements:

We recognize revenue under multiple-element arrangements using the residual method when vendor-specific objective evidence (VSOE) of fair value exists for all of the undelivered elements under the arrangement. Under the residual method, the arrangement consideration is first allocated to undelivered elements based on vendor-specific objective evidence of the fair value for each element and the residual amount is allocated to the delivered elements. Arrangement consideration allocated to undelivered elements is deferred and recognized as revenue when the elements are delivered, if all other revenue recognition criteria are met. We have established sufficient vendor-specific objective evidence for the value of our consulting, training, and other services, based on the price charged when these elements are sold separately. VSOE of the fair value of maintenance services may also be determined based on a substantive renewal clause, if any, within a customer contract. Accordingly, software license revenue is recognized under the residual method in arrangements in which software is licensed with maintenance, consulting, training or other services.

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License Revenue

We receive and recognize licensing fees and royalty revenue from: (1) Original Equipment Manufacturer (OEM) and Independent Software Vendor (ISV) customers for font rendering and page composition technologies; (2) direct and indirect licenses of software publishing applications for the creation, enhancement, management, transport, viewing and printing of electronic information; (3) direct sales of custom design and consulting services to end users such as graphic artists, desktop publishers, corporations and resellers; and (4) sales of fonts and publishing applications to foreign customers primarily through distributors and resellers.

Certain OEM and ISV customers pay royalties only upon the sublicensing of our products to end-users. We recognize revenue in such transactions in the period when sublicenses to end users are reported to us by our OEM or ISV customers. We recognize revenue from guaranteed minimum royalty licenses upon delivery of the software license when no further obligations of the Company exist. In certain guaranteed minimum royalty licenses, we will enter into extended payment programs with creditworthy customers. We recognize revenue related to extended payment programs is recognized when payment becomes due to the Company.

We recognize license revenue from the resale of our products through various resellers. Resellers may sell our products in either an electronic format or CD format. Revenue is recognized if collection is probable, upon notification from the reseller that it has sold the product, or for a CD product, upon delivery of the software.

Revenue from end user product sales is recognized upon delivery of the software and when collection is probable. Revenue related to extended payment programs is recognized when payment becomes due to the Company. End user sales include e-commerce revenue generated from our websites from the licensing of Bitstream fonts, subscription licenses for our browser, licensing of fonts 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 and nine months ended September 30, 2010 was $11 and $34, respectively. Referral income for the three and nine months ended September 30, 2009 was $9 and $31, respectively. There are minimal costs associated with the referral program, and primarily represent the time to load copies of the fonts provided by each participating foundry for addition to the MyFonts.com database. We expense those costs as incurred.

Service Revenue

Professional services include custom design and development and training. We recognize professional services revenue under software development contracts as services are provided for per diem contracts or by using the percentage-of-completion method of accounting for long-term fixed price contracts. Provisions for any estimated losses on contracts are made in the period in which such losses become probable.

We recognize revenue from support and maintenance agreements ratably over the term of the agreement.

Deferred revenue includes unearned software support and maintenance revenue, advance billings under contracts, and advanced billings for unrecognized revenue from licenses.

Cost of revenue from software licenses consists primarily of royalties paid to third party developers and foundries whose products we sell, and costs to distribute the product, including the cost of the media on which it is delivered. Cost of revenue from services consists primarily of costs associated with customer support, consulting and custom product development services.

We generally warrant that our products will function substantially in accordance with documentation provided to customers for approximately 90 days following initial delivery. We have not incurred any material expenses related to warranty claims.

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Stock-based Compensation

We account for stock-based compensation in accordance with authoritative guidance and have elected the modified-prospective method, under which prior periods are not revised for comparative purposes. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period.

We currently use the Black-Scholes option pricing model to determine the fair value of stock options and awards. The determination of the fair value of stock-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables. These variables include our expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends.

We estimate the expected term of options granted by calculating the average term from our historical stock option exercise experience. We estimate the volatility of our common stock by historical volatility. We base the risk-free interest rate that we use in the option pricing model on zero-coupon yields implied from U.S. Treasury issues with remaining terms similar to the expected term on the options. We do not anticipate paying any cash dividends in the foreseeable future and therefore use an expected dividend yield of zero in the option pricing 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.

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods or if we decide to use a different valuation model, stock-based compensation expense in future periods may differ significantly from what we have recorded in the current period and could materially affect our operating income, net income and net income per share.

The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics not present in our option grants and awards. Existing valuation models, including the Black-Scholes and lattice binomial models, may not provide reliable measures of the fair values of our stock-based compensation. Consequently, there is a risk that our estimates of the fair values of our stock-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination or forfeiture of those stock-based payments in the future. Certain stock-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that are significantly higher than the fair values originally estimated on the grant date and reported in our financial statements. There currently is no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values.

The application of these principles using authoritative guidance may be subject to further interpretation and refinement over time. There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and materially affect the fair value estimate of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods and assumptions.

Impairment of Long-Lived Assets

In accordance with authoritative guidance, we test recorded goodwill for impairment. Goodwill is tested for impairment based upon an enterprise wide valuation under one reporting unit. We conducted impairment testing as of December 31, 2009 and determined that the fair value of the enterprise was greater than its carrying value. Although none of the goodwill was impaired, there can be no assurance that, upon completion of a future review, a material impairment charge will not be required.

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Accounts Receivable

We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer s current credit worthiness, as determined by our review of their current credit information. We continuously monitor collections and payments from customers and maintain a provision for estimated credit losses based on our historical experience and any specific customer collection issues that we identify. While such credit losses have historically been within our expectations and appropriate reserves have been established, we increased these reserves throughout 2009, and subsequently wrote-off several accounts during the nine months ended September 30, 2010, as the downturn in the global economy has affected our customers and made collections from certain customers difficult. See Note 1(d) Off-Balance Sheet Risk and Concentration of Credit Risk. We cannot guarantee that our credit loss rates will not continue to worsen or that we will experience credit loss rates approximating those that we have experienced in the past.

Income Taxes

As part of the process of preparing consolidated financial statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that we will recover our deferred tax assets from future taxable income and, to the extent we believe recovery unlikely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the statement of operations. Determination of our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets requires significant management judgment. We