

RIMAGE CORP  
Form 10-Q  
August 08, 2008  
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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED **June 30, 2008**; 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: **000-20728**

**RIMAGE CORPORATION**

(Exact name of registrant as specified in its charter)

**Minnesota**

(State or other jurisdiction of  
incorporation or organization)

**41-1577970**

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

**7725 Washington Avenue South, Edina, MN 55439**

(Address of principal executive offices)

**952-944-8144**

(Registrant's telephone number, including area code)

**NA**

(Former name, former address and former fiscal year, if changed since last report)

Common Stock outstanding at July 31, 2008 9,518,408 shares

of \$.01 par value Common Stock.

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. **Yes x No o**

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

**Large Accelerated Filer o Accelerated Filer x Non-Accelerated Filer o Smaller Reporting Company o**

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

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**RIMAGE CORPORATION**

**FORM 10-Q**

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**FOR THE QUARTER ENDED JUNE 30, 2008**

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**PART 1 FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**RIMAGE CORPORATION AND SUBSIDIARIES**

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**Condensed Consolidated Balance Sheets**

(unaudited in thousands, except share data)

| Assets  | June 30,<br>2008 | December 31,<br>2007 |
|---|------------------|----------------------|
| Current assets:   |                  |                      |
| Cash and cash equivalents   | \$ 23,427        | \$ 7,416             |
| Marketable securities   | 34,544           | 51,605               |
| Receivables, net of allowance for doubtful accounts and sales returns of \$711 and \$583, respectively                    | 13,851           | 14,447               |
| Inventories   | 6,176            | 8,075                |
| Prepaid income taxes  | 1,293            |                      |
| Prepaid expenses and other current assets   | 1,317            | 1,591                |
| Deferred income taxes - current   | 1,462            | 1,637                |
| Total current assets  | 82,070           | 84,771               |
| Marketable securities - non-current   | 35,693           | 35,201               |
| Property and equipment, net   | 2,921            | 3,206                |
| Deferred income taxes - non-current   | 2,199            | 1,918                |
| Total assets  | \$ 122,883       | \$ 125,096           |
| Liabilities and Stockholders' Equity  |                  |                      |
| Current liabilities:  |                  |                      |
| Trade accounts payable  | \$ 4,972         | \$ 7,564             |
| Accrued compensation  | 2,514            | 3,138                |
| Other accrued expenses  | 1,029            | 1,157                |
| Income taxes payable  |                  | 685                  |
| Deferred income and customer deposits   | 5,127            | 5,281                |
| Other current liabilities   | 78               | 57                   |
| Total current liabilities   | 13,720           | 17,882               |
| Long-term liabilities:  |                  |                      |
| Deferred income and customer deposits - non-current   | 1,589            | 1,930                |
| Income taxes payable - non-current  | 443              | 164                  |
| Other non-current liabilities   | 47               | 59                   |
| Total long-term liabilities   | 2,079            | 2,153                |
| Total liabilities   | 15,799           | 20,035               |
| Stockholders' equity:   |                  |                      |
| Preferred stock, \$.01 par value, authorized 250,000 shares, no shares issued and outstanding                             |                  |                      |
| Common stock, \$.01 par value, authorized 29,750,000 shares, issued and outstanding 9,628,408 and 9,705,947, respectively | 96               | 97                   |
| Additional paid-in capital  | 36,575           | 33,827               |
| Retained earnings   | 69,180           | 70,462               |
| Accumulated other comprehensive income  | 1,233            | 675                  |
| Total stockholders' equity  | 107,084          | 105,061              |
| Total liabilities and stockholders' equity  | \$ 122,883       | \$ 125,096           |

See accompanying notes to condensed consolidated financial statements.

Table of Contents**RIMAGE CORPORATION AND SUBSIDIARIES****Condensed Consolidated Statements of Income**

(unaudited in thousands, except per share data)

|   | Three Months Ended |           | Six Months Ended |           |
|---|--------------------|-----------|------------------|-----------|
|   | June 30,<br>2008   | 2007      | June 30,<br>2008 | 2007      |
| Revenues                                    | \$ 22,686          | \$ 25,486 | \$ 45,435        | \$ 47,012 |
| Cost of revenues                            | 12,772             | 14,088    | 25,844           | 25,866    |
| Gross profit                                | 9,914              | 11,398    | 19,591           | 21,146    |
| Operating expenses:                         |                    |           |                  |           |
| Research and development                    | 1,513              | 1,441     | 2,864            | 3,031     |
| Selling, general and administrative         | 5,672              | 6,284     | 12,310           | 12,112    |
| Total operating expenses                    | 7,185              | 7,725     | 15,174           | 15,143    |
| Operating income                            | 2,729              | 3,673     | 4,417            | 6,003     |
| Other income (expense):                     |                    |           |                  |           |
| Interest, net                               | 676                | 861       | 1,512            | 1,664     |
| Loss on currency exchange                   | (410 )             | (95 )     | (163 )           | (89 )     |
| Other, net                                  | 21                 | (7 )      | 20               | 13        |
| Total other income, net                     | 287                | 759       | 1,369            | 1,588     |
| Income before income taxes                  | 3,016              | 4,432     | 5,786            | 7,591     |
| Income tax expense                          | 1,089              | 1,511     | 2,073            | 2,548     |
| Net income                                  | \$ 1,927           | \$ 2,921  | \$ 3,713         | \$ 5,043  |
| Net income per basic share                  | \$ 0.20            | \$ 0.29   | \$ 0.38          | \$ 0.50   |
| Net income per diluted share                | \$ 0.19            | \$ 0.28   | \$ 0.37          | \$ 0.48   |
| Basic weighted average shares outstanding   | 9,662              | 10,105    | 9,712            | 10,042    |
| Diluted weighted average shares outstanding | 9,820              | 10,585    | 9,946            | 10,550    |

See accompanying notes to condensed consolidated financial statements.

Table of Contents**RIMAGE CORPORATION AND SUBSIDIARIES**

**Condensed Consolidated Statements of Cash Flows****(unaudited in thousands)**

|   | <b>Six months ended</b> |             |
|---|-------------------------|-------------|
|   | <b>June 30,</b>         |             |
|   | <b>2008</b>             | <b>2007</b> |
| Cash flows from operating activities:   |                         |             |
| Net income  | \$ 3,713                | \$ 5,043    |
| Adjustments to reconcile net income to net cash provided by operating activities: |                         |             |
| Depreciation and amortization   | 725                     | 787         |
| Deferred income tax benefit   | (171 )                  | (173 )      |
| Loss on disposal of property and equipment  | 3                       | 101         |
| Stock-based compensation  | 298                     | 549         |
| Excess tax benefits from stock-based compensation                                 | (701 )                  | (963 )      |
| Changes in operating assets and liabilities:                                      |                         |             |
| Receivables   | 596                     | 2,297       |
| Inventories   | 1,898                   | (1,406 )    |
| Prepaid income taxes/income taxes payable   | (731 )                  | (1,438 )    |
| Prepaid expenses and other current assets   | 274                     | 27          |
| Trade accounts payable  | (2,572 )                | 666         |
| Accrued compensation  | (624 )                  | (181 )      |
| Other accrued expenses and other current liabilities                              | (106 )                  | (158 )      |
| Deferred income and customer deposits   | (495 )                  | 2,414       |
| Net cash provided by operating activities   | 2,107                   | 7,565       |
| Cash flows from investing activities:   |                         |             |
| Purchases of marketable securities  | (34,760)                | (21,426)    |
| Maturities of marketable securities   | 51,496                  | 20,721      |
| Purchases of property and equipment   | (463 )                  | (826 )      |
| Other non-current items   | 344                     | 74          |
| Net cash provided by (used in) investing activities                               | 16,617                  | (1,457 )    |
| Cash flows from financing activities:   |                         |             |
| Principal payments on capital lease obligations                                   | (12 )                   | (5 )        |
| Repurchase of common stock  | (4,999 )                |             |
| Excess tax benefits from stock-based compensation                                 | 701                     | 963         |
| Proceeds from employee stock plans  | 1,485                   | 1,813       |
| Net cash provided by (used in) financing activities                               | (2,825 )                | 2,771       |
| Effect of exchange rate changes on cash   | 112                     | 20          |
| Net increase in cash and cash equivalents   | 16,011                  | 8,899       |
| Cash and cash equivalents, beginning of period                                    | 7,416                   | 8,500       |
| Cash and cash equivalents, end of period  | \$ 23,427               | \$ 17,399   |
| Supplemental disclosures of net cash paid during the period for:                  |                         |             |
| Income taxes  | \$ 2,976                | \$ 4,163    |

See accompanying notes to condensed consolidated financial statements.

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**RIMAGE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**(1) Basis of Presentation and Nature of Business**

Rimage Corporation ( the Company or Rimage ) develops, manufactures and markets digital publishing systems that are used by businesses to produce recordable CD ( CD-R ), DVD ( DVD-R ) and blue laser discs with customized digital content on an on-demand basis. Rimage distributes its publishing systems from its operations in the United States, Germany and Japan. The Company also distributes related consumables for use with its systems, consisting of media kits, ribbons, ink cartridges and Rimage-branded blank CD-R and DVD-R media.

The accompanying condensed consolidated financial statements of Rimage are unaudited and have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial information, pursuant to the rules and regulations of the Securities and Exchange Commission. Pursuant to such rules and regulations, certain financial information and footnote disclosures normally included in the financial statements have been condensed or omitted. However, in the opinion of management, the financial statements include all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the financial position and results of operations and cash flows of the interim periods presented. Operating results for these interim periods are not necessarily indicative of results to be expected for the entire year, due to seasonal, operating and other factors. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K as of and for the year ended December 31, 2007.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**(2) Stock-Based Compensation**

In May 2007, the Company s shareholders approved the 2007 Stock Incentive Plan (the 2007 Plan ). The 2007 Plan provides for the grant of stock incentive awards in the form of incentive and non-qualified stock options, stock appreciation rights, restricted stock, restricted stock units, performance stock, performance units and other awards in stock and/or cash to certain key employees, non-employee directors and service providers. The 2007 Plan permits the issuance of up to 730,320 shares of the Company s common stock. At June 30, 2008, a total of 321,595 shares were available for future grant under the 2007 Plan. Effective with the approval of the 2007 Plan in May 2007, the Company may not issue any new awards or options under its Amended and Restated 1992 Stock Option Plan (the 1992 Plan ). The exercise price of stock options granted under the 2007 Plan is equal to the market value on the date of grant. Options issued to employees through March 31, 2006 under the 1992 Plan generally become exercisable over a two-year period and terminate ten years from the date of grant. Options issued to employees after March 31, 2006 under both the 1992 Plan and the 2007 Plan generally become exercisable over a four-year period.

Table of Contents**RIMAGE CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)**

Options issued to employees through May 13, 2008 terminate ten years from the date of grant, while options issued effective May 14, 2008 terminate seven years from the date of grant. Stock options granted to non-employee directors vest six months from the date of grant and terminate ten years from the date of grant. Restricted shares issued to non-employee directors under the 2007 Plan are subject to the risk of forfeiture and transfer restrictions that lapse one year from the date of grant.

In accordance with Statement of Financial Accounting Standards ( SFAS ) No. 123R, Share-Based Payment, stock-based compensation expense is determined based on the grant-date fair value and is recognized on a straight-line basis over the vesting period for each stock-based award granted on or after January 1, 2006, and for previously granted awards not yet vested as of January 1, 2006. Compensation cost is recognized for all awards over the vesting period to the extent the employees or directors meet the requisite service requirements, whether or not the award is ultimately exercised. Conversely, when an employee or director does not meet the requisite service requirements and forfeits the award prior to vesting, any compensation expense previously recognized for the award is reversed. The Company recognized stock-based compensation costs of \$104,000 and \$297,000 for the three and six months ended June 30, 2008, respectively, compared to \$338,000 and \$550,000 for the comparable periods in 2007. Costs recognized in the current-year periods include the impact of the reversal in the second quarter of approximately \$0.2 million in expenses stemming from the forfeiture of unvested stock options held by terminated employees.

The fair value of each option award is estimated at the date of grant using the Black-Scholes option pricing model. The following key assumptions were utilized in valuing option awards issued during the six months ended June 30, 2008 and 2007:

|                                   | <b>Six Months Ended June 30,</b> |              |
|-----------------------------------|----------------------------------|--------------|
|                                   | <b>2008</b>                      | <b>2007</b>  |
| Expected life of options in years | 4.75 - 6.00                      | 6.00         |
| Risk-free interest rate           | 3.1%                             | 4.5 - 4.8%   |
| Expected volatility               | 39.1 - 40.0%                     | 39.0 - 40.0% |
| Expected dividend yield           | 0.0%                             | 0.0%         |

In accordance with SFAS No. 123R, the Company reviews these assumptions at the time of each new option award and adjusts them as necessary to ensure proper option valuation. The expected life represents the period that the stock option awards are expected to be outstanding and is determined based on an analysis of historical exercise behavior and anticipated future exercise patterns, giving consideration to the contractual terms of unexercised stock option awards. The risk-free interest rate is based on the yield of constant maturity U.S. treasury bonds with a remaining term equal to the expected life of the awards. The Company estimated the stock price volatility using historical weekly price observations over the expected life of the awards. The expected dividend yield is zero as the Company has not paid or declared any cash dividends on its common stock and does not currently have plans to pay dividends.



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Other information pertaining to stock options is as follows:

|  | <b>Three Months Ended June 30,</b>           |             | <b>Six Months Ended June 30,</b> |             |
|--|--|-------------|----------------------------------|-------------|
|  | <b>2008</b>                                  | <b>2007</b> | <b>2008</b>                      | <b>2007</b> |
|  | <b>(in thousands, except per share data)</b> |             |                                  |             |
| Number of options granted                                | 184  | 235         | 184                              | 245         |
| Fair value of options granted                            | \$ 1,282                                     | \$ 2,881    | \$ 1,282                         | \$ 3,002    |
| Per share weighted average fair value of options granted | \$ 6.98                                      | \$ 12.25    | \$ 6.98                          | \$ 12.25    |
| Total fair value of stock options vested                 | \$ 879                                       | \$ 461      | \$ 879                           | \$ 783      |
| Total intrinsic value of stock options exercised         | \$ 562                                       | \$ 255      | \$ 2,592                         | \$ 3,476    |
| Total intrinsic value of stock options outstanding       | \$ 899                                       | \$ 20,357   | \$ 899                           | \$ 20,357   |

Cash received from the exercise of stock options was \$1,485,000 and \$1,813,000 for the six months ended June 30, 2008 and 2007, respectively. The income tax benefit realized from the exercise of stock options and recorded as an increase to additional paid-in capital was \$968,000 and \$1,204,000 for the six months ended June 30, 2008 and 2007, respectively.

**(3) Accounting for Uncertainty in Income Taxes**

The Company implemented the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. ( FIN ) 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, effective January 1, 2007. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This interpretation prescribes a recognition threshold and measurement criteria for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Gross unrecognized tax benefits as of June 30, 2008 and December 31, 2007 totaled \$380,000 and \$187,000, respectively. Changes in gross unrecognized tax benefits consisted of an increase of \$48,000 for tax positions taken in the current year and a decrease of \$72,000 resulting from settlements with state taxing authorities. An additional increase of \$217,000 resulted from a balance sheet reclassification of a deferred tax asset that had previously been offset in unrecognized tax benefits as of December 31, 2007. Included in the balance of unrecognized tax benefits at June 30, 2008 are potential benefits of \$143,000 that if recognized, would affect the effective tax rate. The difference between this amount and the corresponding amount of gross

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unrecognized tax benefits relates primarily to the deferred federal benefit for state and foreign income tax related amounts.

The Company recognizes accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. Total accrued interest and penalties amounted to \$63,000 and \$49,000 on a gross basis at June 30, 2008 and December 31, 2007, respectively, and are excluded from the gross amounts of unrecognized tax benefits reflected above. Interest and penalties recognized in the accompanying Condensed Consolidated Statements of Income related to uncertain tax positions amounted to \$17,000 for the six months ended June 30, 2008.

The Company files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. As of June 30, 2008, the Company was no longer subject to income tax examinations for taxable years before 2006 and 2005 in the case of U.S. federal and German taxing authorities, respectively, and taxable years generally before 2003 in the case of state taxing authorities, consisting primarily of Minnesota, California and Maryland.

**(4) Marketable Securities**

Marketable securities consist primarily of municipal securities, U.S. government agency and money market securities and corporate securities with long-term credit ratings of AAA and short-term credit ratings of A-1. Marketable securities are classified as short-term or long-term in the balance sheet based on their effective maturity date. All marketable securities, except for variable rate demand notes, have maturities ranging from three to 36 months. Variable rate demand notes may be liquidated in less than three months from the date of purchase, but have legal maturities of greater than three months and are required to be classified as marketable securities. Marketable securities are classified as available-for-sale. Available-for-sale securities are recorded at fair value and any unrealized holding gains and losses, net of the related tax effect, are excluded from earnings and are reported as a separate component of accumulated other comprehensive income until realized. See Note 8, Fair Value Measurements, for a discussion of inputs used to measure the fair value of the Company's available-for-sale securities. The Company's investment portfolio at June 30, 2008 did not include any auction-rate securities, high-yield sub-prime backed paper or other affected securities which are subject to significant market value declines or liquidity issues.

**(5) Inventories**

Inventories consisted of the following (in thousands):

|  | <b>June 30,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|--|--------------------------|------------------------------|
| Finished goods and demonstration equipment | \$ 1,842                 | \$ 1,879                     |
| Purchased parts and subassemblies          | 4,334                    | 6,196                        |

\$6,176

\$8,075

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Comprehensive income consists of the Company's net income, foreign currency translation adjustments and unrealized holding gains and losses from available-for-sale securities. The components of and changes in other comprehensive income are as follows (in thousands):

|   | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|---|---------------------------|-------------|-------------------------|-------------|
|   | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|   | <b>2008</b>               | <b>2007</b> | <b>2008</b>             | <b>2007</b> |
| Net income  | \$1,927                   | \$2,921     | \$3,713                 | \$5,043     |
| Other comprehensive income:                                       |                           |             |                         |             |
| Net changes in:   |                           |             |                         |             |
| Foreign currency translation adjustments                          | 309                       | 70          | 456                     | 94          |
| Net unrealized gain (loss) on marketable securities, net of taxes | (199)                     | (116)       | 103                     | (115)       |
| Total comprehensive income  | \$2,037                   | \$2,875     | \$4,272                 | \$5,022     |

**(7) Foreign Currency Contracts**

The Company enters into forward foreign exchange contracts to hedge intercompany receivables denominated in Euros arising from sales to its subsidiary in Germany. Gains or losses on forward foreign exchange contracts are calculated at each period end and are recognized in net income in the period in which they arose. The fair value of forward foreign exchange contracts is recorded in other current assets or other current liabilities depending on whether the net amount is a gain or a loss.

As of June 30, 2008, the Company had fourteen outstanding foreign currency contracts totaling approximately \$3,305,000. These contracts mature during 2008 and bear exchange rates ranging from 1.5268 to 1.5785 U.S. Dollars per Euro. As of June 30, 2008, the fair value of foreign currency contracts resulted in a net loss position of \$55,000, which is recorded in other current liabilities.

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As of December 31, 2007, the Company had 20 outstanding foreign currency contracts totaling \$3,981,000, all maturing during the first half of 2008 at exchange rates ranging from 1.4041 to 1.4810 U.S. Dollars per Euro. As of December 31, 2007, the fair value of foreign currency contracts resulted in a net loss position of approximately \$34,000, which is recorded in other current liabilities.

### (8) Fair Value Measurements

The Company adopted SFAS No. 157, Fair Value Measurements, for financial assets and liabilities on January 1, 2008. SFAS No. 157 defines fair value and establishes a framework for measuring fair value. This statement applies only to fair value measurements that are already required or permitted by other accounting standards, except for measurements of share-based payments and measurements that are similar to, but not intended to be, fair value. In February 2008, FASB Staff Position No. 157-2 was issued which delayed the effective date of FASB Statement No. 157 to fiscal years ending after November 15, 2008 for nonfinancial assets and liabilities, except for

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## RIMAGE CORPORATION AND SUBSIDIARIES

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Although the adoption of SFAS No. 157 for financial assets and liabilities did not impact the Company's financial statements, additional disclosures about fair value measurements are required.

SFAS No. 157 establishes a framework for measuring fair value by creating a hierarchy of fair value measurements that distinguishes market data between observable independent market inputs and unobservable market assumptions by the reporting entity, as highlighted in the table below. The Company's assets and liabilities measured at fair value on a recurring basis subject to the disclosure requirements of SFAS No. 157 were as follows at June 30, 2008:

|   | Total Carrying<br>Value at<br>June 30, 2008 | Fair Value Measurements Using<br>Significant       |  |  |
|---|---|--|--|--|
|   |   | Quoted Prices<br>in<br>Active Markets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (in thousands)                              |   |  |  |  |
| <b>Assets</b>                               |   |  |  |  |
| Available-for-sale securities               | \$ 85,594                                   | \$   | \$ 85,594                                  | \$   |
| <b>Liabilities</b>                          |   |  |  |  |
| Foreign currency forward exchange contracts | \$ 55                                       | \$   | \$ 55                                      | \$   |

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Available-for-sale securities are carried at fair value based on significant observable inputs other than quoted market prices. Foreign currency forward exchange contracts are also carried at fair value based on significant other observable market inputs, in this case, quoted foreign currency exchange rates. Such valuation represents the amount the Company would receive or pay to terminate the forward exchange contracts at the reporting date.

The Company adopted SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an Amendment of FASB Statement No. 115, on January 1, 2008. This standard permits entities to choose to measure many financial instruments and certain other items at fair value. This statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Unrealized gains and losses on items for which the fair value option is elected would be reported in earnings. The Company has not elected the fair value measurement option for any of its financial assets or liabilities as of June 30, 2008, and the Company has not determined whether or not it will elect this option for financial instruments it may acquire in the future.

### **(9) Common Stock Repurchase Authorizations**

On October 17, 2007, the Company's Board of Directors authorized the repurchase of up to 500,000 shares of its common stock. In February 2008, the Company's Board of Directors increased the share repurchase authorization by an additional 500,000 shares, bringing total shares authorized for repurchase to 1,000,000. Shares will be purchased at prevailing market prices in the open market or

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#### **RIMAGE CORPORATION AND SUBSIDIARIES**

#### **NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

in private transactions, subject to market conditions, share price, trading volume and other factors. The repurchase program may be discontinued at any time. The Company will finance the purchase of the shares using cash on hand. During the three and six months ended June 30, 2008, the Company repurchased 248,800 and 275,310 shares, respectively, of its common stock at an average purchase price of \$17.66 and \$18.16 per share for each respective period under the authorizations. As of June 30, 2008, there were 724,690 shares available for repurchase under the authorizations.

Subsequent to June 30, 2008 and through August 6, 2008, the Company repurchased an additional 132,100 shares of its common stock at an average purchase price of \$15.12 per share, and expects to repurchase additional shares under the terms of its share repurchase program.

### **(10) Recently Issued Accounting Standards**

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In December 2007, the FASB issued SFAS No. 141R (revised 2007), Business Combinations. SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired in the business combination. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141R becomes effective for business combinations occurring on or after January 1, 2009, and early adoption is prohibited.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51. SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. The provisions of SFAS No. 160 are effective for the Company beginning January 1, 2009. The Company is currently evaluating the impact of adopting this pronouncement on its consolidated financial statements and related disclosures.

### (11) Computation of Net Income Per Share of Common Stock

Basic net income per common share is determined by dividing net income by the weighted average number of shares of common stock outstanding. Diluted net income per common share includes the potentially dilutive effect of common shares issued in connection with outstanding stock options using the treasury stock method. Stock options to acquire 720,000 and 553,000 weighted average common shares for the three and six months ended June 30, 2008 and 306,000 and 255,000 weighted average common shares for the three and six months ended June 30, 2007 have been excluded from the computation of diluted weighted average shares outstanding for each respective period as their effect is anti-dilutive. The following is a summary of the weighted average common shares outstanding and diluted potential common shares (in thousands, except for per share data):

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## RIMAGE CORPORATION AND SUBSIDIARIES

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

|  | Three Months Ended |        | Six Months Ended |        |
|--|--------------------|--------|------------------|--------|
|  | June 30,<br>2008   | 2007   | June 30,<br>2008 | 2007   |
| Shares outstanding at end of period                            | 9,628              | 10,120 | 9,628            | 10,120 |
| Weighted average shares outstanding                            | 9,665              | 10,105 | 9,714            | 10,042 |
| Restricted stock effect on weighted average shares outstanding | (3 )               |        | (1 )             |        |
| Total basic weighted average shares outstanding                | 9,662              | 10,105 | 9,713            | 10,042 |
| Weighted average shares outstanding                            | 9,665              | 10,105 | 9,714            | 10,042 |
| Weighted average potential common shares                       | 155                | 480    | 232              | 508    |

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|   |          |          |          |          |
|---|----------|----------|----------|----------|
| Total diluted weighted average shares outstanding | 9,820    | 10,585   | 9,946    | 10,550   |
| Net income  | \$ 1,927 | \$ 2,921 | \$ 3,713 | \$ 5,043 |
| Basic net income per common share                 | \$ 0.20  | \$ 0.29  | \$ 0.38  | \$ 0.50  |
| Diluted net income per common share               | \$ 0.19  | \$ 0.28  | \$ 0.37  | \$ 0.48  |

(12) Contingencies

The Company is exposed to a number of asserted and unasserted claims encountered in the normal course of business. In the opinion of management, the resolution of these matters will not have a material adverse effect on the Company's financial position or results of operations.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following table sets forth, for the periods indicated, selected items from the Company's condensed consolidated statements of income.

|                                     | Percentage (%)     |       | Percentage (%) | Percentage (%)   |       | Percentage (%) |
|-------------------------------------|--------------------|-------|----------------|------------------|-------|----------------|
|                                     | of Revenues        |       | Incr/(Decr)    | of Revenues      |       | Incr/(Decr)    |
|                                     | Three Months Ended |       | Between        | Six Months Ended |       | Between        |
|                                     | June 30,           |       | Periods        | June 30,         |       | Periods        |
|                                     | 2008               | 2007  | 2008 vs. 2007  | 2008             | 2007  | 2008 vs. 2007  |
| Revenues                            | 100                | 100   | (11 )          | 100              | 100   | (3 )           |
| Cost of revenues                    | (56 )              | (55 ) | (9 )           | (57 )            | (55 ) |                |
| Gross profit                        | 44                 | 45    | (13 )          | 43               | 45    | (7 )           |
| Operating expenses:                 |                    |       |                |                  |       |                |
| Research and development            | (7 )               | (6 )  | 5              | (6 )             | (6 )  | (6 )           |
| Selling, general and administrative | (25 )              | (25 ) | (10 )          | (27 )            | (26 ) | 2              |
| Operating income                    | 12                 | 14    | (26 )          | 10               | 13    | (26 )          |
| Other income, net                   | 1                  | 3     | (62 )          | 3                | 3     | (14 )          |
| Income before income taxes          | 13                 | 17    | (32 )          | 13               | 16    | (24 )          |
| Income tax expense                  | (5 )               | (6 )  | (28 )          | (5 )             | (5 )  | (19 )          |
| Net income                          | 8                  | 11    | (34 )          | 8                | 11    | (26 )          |

**Overview**

Rimage develops, manufactures and markets digital publishing systems that are used by businesses to produce recordable CD, DVD and blue laser discs with customized digital content on an on-demand basis. Rimage distributes its publishing systems from its operations in the United States, Germany and Japan. These systems allow customers to benefit from cost savings by reducing or eliminating their manual labor efforts in

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industries such as digital photography, medical imaging and business services. Rimage anticipates increased sales and marketing expenditures in 2008 as a result of increased resources focused on developing these markets. As Rimage's sales within North America and Europe have averaged 94% of total sales over the past three years, the strength of the economies in these regions plays an important role in determining the success of Rimage.

Rimage earns revenues through the sale of equipment, consumables (ribbons, ink cartridges and Rimage-branded blank CD-R and DVD-R media), maintenance contracts, parts and repair services. Rimage's recurring revenues (consumables, maintenance contracts, parts and service) comprised approximately 60% and 49% of its consolidated revenues during the six months ended June 30, 2008 and 2007, respectively. Exclusive of a small amount of capital lease obligations, Rimage has no long-term debt and does not require significant capital investment for its ongoing operations as all fabrication of its products is outsourced to vendors.

### Results of Operations

**Revenues.** Consolidated revenues decreased 11% and 3% to \$22.7 million and \$45.4 million for the three and six months ended June 30, 2008, respectively, from \$25.5 million and \$47.0 million for the respective prior-year periods. The reduction in revenues resulted from decreased sales of Producer and Desktop product line equipment of \$4.0 million and \$5.7 million for the three and six months ended June 30, 2008, respectively, compared to the same periods in the prior year. The

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#### **Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

overall decline in the volume of equipment sales was primarily due to deliveries against significant orders from the retail market segment during the prior year's second quarter, compared to minimal equipment sales in this market segment in the current-year periods. Sales of Producer product line equipment comprised 35% and 33% of total revenues for the three and six months ended June 30, 2008, respectively, compared to 44% and 41% for the same periods in the prior year. Sales of Desktop product line equipment represented 7% of revenues for the three and six months ended June 30, 2008, respectively, compared to 9% and 10% in the respective prior-year periods. Partially offsetting the decrease in equipment sales was an increase in the volume of recurring revenues of \$1.2 million and \$4.1 million for the three and six months ended June 30, 2008, respectively, compared to the same periods in the prior year. The growth in recurring revenues was primarily due to the continued expansion of the Company's worldwide installed base of CD-R and DVD-R publishing systems and the Company's increased emphasis on promoting this portion of its business. Recurring revenues comprised 58% and 60% of total revenues for the three and six months ended June 30, 2008, respectively, compared to 47% and 49% in the same prior-year periods.

International sales rose 23% and 19% for the three and six months ended June 30, 2008 over the same prior-year periods, and comprised 47% and 45% of total sales, compared to 34% and 37% for the same periods in the prior year. Currency fluctuations affecting the Company's European and Japanese operations generated a significant portion of the increase in international revenues and increased reported consolidated revenues for the three and six months ended June 30, 2008 by 5.6% and 5.2%, respectively, relative to the same prior-year periods.

As of and for the six months ended June 30, 2008, the Company's German and Japanese operations generated foreign revenues from unaffiliated customers of \$18.1 million, operating income of \$0.1 million and net identifiable assets of \$11.4 million. These amounts were generated



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primarily by the Company's German operations. Comparable amounts for the Company's German and Japanese operations as of and for the six months ended June 30, 2007 were revenues of \$14.9 million, operating income of \$0.1 million and net identifiable assets of \$8.4 million. The growth in revenues and assets was favorably impacted by foreign currency fluctuations as well as increased penetration in foreign markets of sales of the Company's digital publishing systems.

The Company is estimating that third quarter 2008 consolidated revenues will range between \$21 million and \$23 million.

**Gross profit.** Gross profit as a percentage of revenues was 44% and 43% for the three and six months ended June 30, 2008, respectively, compared to 45% for each of the same periods in 2007. The decline in gross profit as a percentage of revenues for both current-year periods resulted primarily from a shift in the distribution of sales to lower margin products. This shift is driven largely by a reduced volume and concentration of Producer product line equipment sales, which generally carry higher gross margins than Desktop product line equipment or recurring revenues. Sales in the current-year periods also included an increased volume and concentration of sales of media and media kits, which generally carry lower margins than other product offerings, comprising 18% and 19% of revenues for the three and six months ended June 30, 2008, respectively, compared to 11% and 12% in the same prior-year periods. Additionally, the Company charged severance related expenses of approximately \$0.1 million to cost of sales in the second quarter 2008 as a result

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#### **Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

of a work force reduction in the Company's U.S. operations. Partially offsetting the unfavorable impact on gross profit as a percentage of revenue of the described changes in product mix and severance charges was an improvement in service related margins, as revenues from maintenance contracts and other services increased at a faster rate than their related costs during the three and six months ended June 30, 2008 compared to the same prior-year periods. Gross margin was also favorably impacted by reduced inventory related charges to cost of sales in the second quarter of 2008 compared to the same period in 2007 of approximately \$0.3 million.

Future gross profit margins will continue to be affected by many factors, including product mix, the timing of new product introductions, changes in material costs, manufacturing volume, the rate of growth of service related revenues relative to associated service support costs and foreign currency exchange rate fluctuations.

**Operating expenses.** Research and development expenses totaled \$1.5 million and \$2.9 million for the three and six months ended June 30, 2008, respectively, representing 7% and 6% of revenues for each period, respectively. Expenses for the same prior-year periods totaled \$1.4 million and \$3.0 million, representing 6% of revenues for both periods. The moderate changes in expenses between periods were primarily due to the timing of activities associated with new product development projects and enhancements to existing products. Rimage anticipates expenditures in research and development in 2008 to continue at levels similar to that of this year's second quarter to support new product development initiatives and to improve existing products.

Selling, general and administrative expenses for the three and six months ended June 30, 2008 amounted to \$5.7 million and \$12.3 million, respectively, or 25% and 27% of revenues, compared to expenses in the same prior-year periods of \$6.3 million and \$12.1 million, respectively,

or 25% and 26% of revenues. Expenses for the current-year periods include severance related costs approximating \$0.2 million as a result of a work force reduction in the Company's U.S. operations in the second quarter. Such expenses are comparable to severance related charges incurred in the second quarter of 2007 of approximately \$0.2 million. Currency fluctuations affecting the Company's European and Japanese operations increased selling, general and administrative expenses in the current year's second quarter and year-to-date period by \$0.3 million and \$0.5 million, respectively, from the same periods in the prior year. The increased expenses from currency fluctuations were offset in the current year's second quarter, and partially offset in the year-to-date period, by a \$0.2 million and \$0.3 million respective decrease in stock-based compensation costs and lower recurring compensation related costs stemming from the work force reduction described above and fewer senior level personnel relative to the same prior-year periods. Also partially offsetting the impact of currency fluctuations for the six months ended June 30, 2008, were reduced consulting and related expenses of \$0.2 million primarily stemming from the Company's implementation in the prior year's first quarter of a new enterprise resource planning ( ERP ) system in the Company's European operation. Contributing to the net rise in expenses for the current year-to-date period were increased expenditures for travel and sales and marketing promotional programs approximating \$0.3 million to help further develop the Company's global markets and strengthen its sales and marketing organizations.

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**Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

**Other income, net.** The Company recognized net interest income on cash and marketable securities of \$0.7 million and \$1.5 million for the three and six months ended June 30, 2008, respectively, compared to \$0.9 million and \$1.7 million for the same prior-year periods. The \$0.2 million reduction in interest income in each of the current-year periods was the result of a decline in average interest rates approximating one percentage point relative to the same prior-year periods. Partially offsetting the impact of the reduction in interest rates was an \$8 million and \$11 million increase in average cash equivalent and marketable securities balances for the three and six months ended June 30, 2008, respectively, compared to the same periods in the prior year. Other income in each period was unfavorably impacted by net losses on foreign currency transactions, amounting to \$0.4 million and \$0.2 million for the three and six months ended June 30, 2008, respectively, compared to net losses of \$0.1 million for each of the same prior-year periods. The increased losses in the current periods were impacted by larger fluctuations in the rate of exchange between the U.S. dollar and the Japanese Yen and European Euro applied to intercompany receivable balances denominated in these foreign currencies.

**Income taxes.** The provision for income taxes represents federal, state and foreign income taxes on income. Income tax expense for the three and six months ended June 30, 2008 amounted to \$1.1 million and \$2.1 million, or 36.1% and 35.8% of income before taxes, respectively. Income tax expense for the three and six months ended June 30, 2007 was \$1.5 million and \$2.5 million, or 34.1% and 33.6% of income before taxes, respectively. The increase in the effective tax rate for the current-year periods primarily reflects the impact of higher state income taxes and the recognition of a benefit in the prior-year periods for the federal research credit, which has not yet been reinstated for 2008. Additionally, the increase in the year-to-date period was further impacted by the recognition of a benefit in the first quarter 2007 for a reduction in the liability for unrecognized tax benefits related to certain income tax uncertainties. The Company anticipates its effective tax rate will range between 35% and 37% for the full year 2008.

**Net income / net income per share.** Resulting net income for the three and six months ended June 30, 2008 was \$1.9 million and \$3.7 million, respectively, or 8% of revenues for both periods. Comparable amounts for the three and six months ended June 30, 2007 were \$2.9 million and \$5.0 million, respectively, or 11% of revenues for each period. Related net income per diluted share amounts for the three and six months ended June 30, 2008 were \$0.19 and \$0.37, respectively, compared to \$0.28 and \$0.48 per diluted share for the respective prior-year periods. The Company expects third quarter 2008 net income to range from \$0.17 to \$0.23 per diluted share.

**Liquidity and Capital Resources**

The Company expects it will be able to maintain current operations, including anticipated capital expenditure requirements, through its internally generated funds and, if required, from Rimage's existing credit agreement. This credit agreement allows for advances under an unsecured revolving loan up to a maximum advance of \$10 million. At June 30, 2008, no amounts were outstanding under the credit agreement.

At June 30, 2008, the Company had working capital of \$68.4 million, an increase of \$1.5 million from working capital reported at December 31, 2007. The increase was primarily the result of year-to-date net income adjusted for non-cash items of \$4.6 million and proceeds from employee stock

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**Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

plans of \$1.5 million, partially offset by the Company's use of \$5.0 million to repurchase shares of its Company stock, as described below.

On October 17, 2007, the Company's Board of Directors authorized the repurchase of up to 500,000 shares of its common stock. In February 2008, the Company's Board of Directors increased the share repurchase authorization by an additional 500,000 shares, bringing total shares authorized for repurchase to 1,000,000. Shares will be purchased at prevailing market prices in the open market or in private transactions, subject to market conditions, share price, trading volume and other factors. The repurchase program may be discontinued at any time. The Company will finance the purchase of the shares using cash on hand. During the six months ended June 30, 2008, the Company repurchased 275,310 shares of its common stock at an average purchase price of \$18.16 per share under the authorizations. The Company also intends on utilizing its assets primarily for its continued organic growth. Additionally, the Company may use its available cash for potential future strategic initiatives or alliances.

Net cash provided by operating activities totaled \$2.1 million for the six months ended June 30, 2008, compared to \$7.6 million in the same prior-year period. The \$5.5 million reduction in cash generated from operations resulted from changes in operating assets and liabilities producing a net use of cash of \$1.8 million in 2008 compared to a net increase in cash of \$2.2 million in 2007, coupled with a \$1.3 million decrease in net income for the six months ended June 30, 2008 compared to the same prior-year period. Contributing to the change in operating assets and liabilities compared to the prior year's period was a \$1.7 million smaller reduction in receivables, a \$3.6 million larger aggregate reduction in trade accounts payable, accrued compensation and accrued expenses and a \$2.9 million unfavorable variation in the change in deferred income. These changes were partially offset by a \$3.3 million favorable variation in the change in inventories and a \$0.7 million smaller net increase in prepaid income taxes. The smaller reduction in receivables in the current year's period was primarily impacted by a \$0.3 million increase in revenue in June 2008 relative to December 2007 (last month of each quarter), compared to a \$3.0 million decrease in revenue between the comparable prior-year periods. The changes in trade accounts payable, accrued compensation, accrued expenses and prepaid income taxes were primarily due to the timing of related payments. The unfavorable change in deferred income resulted from a larger volume of new maintenance contracts initiated during the first six months of 2007 compared to 2008. The favorable change in inventories resulted from a \$1.9 million reduction in inventories during the current-year period, compared to a \$1.4 million increase in the same prior-year period. The decrease in inventories in the current period resulted primarily from the Company's maintenance of lower levels of buffer inventory stock.

Investing activities provided a net increase in cash of \$16.6 million for the six months ended June 30, 2008 and resulted in a net use of cash of \$1.5 million for the same prior-year period. The fluctuations in investing activities were primarily the result of \$16.7 million in maturities of

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marketable securities, net of related purchases, during the six months ended June 30, 2008, compared to \$0.7 million in purchases of marketable securities, net of related maturities, in the same prior-year period. Capital expenditures for the six months ended June 30, 2008 and 2007 totaled \$0.5 million and \$0.8 million, respectively. Capital expenditures in the current period consisted primarily of purchases of manufacturing tooling and office equipment, while expenditures in the prior-year period consisted primarily of costs capitalized as part of the implementation of an enterprise resource planning system and purchases of manufacturing tooling.

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#### **Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

Financing activities used net cash of \$2.8 million for the six months ended June 30, 2008, and provided net cash of \$2.8 million for the same period in 2007. The net use of cash in the current-year period was primarily attributable to the Company's use of \$5.0 million of cash to repurchase 275,310 shares of its common stock. Partially offsetting the Company's use of cash to repurchase common stock in the current period and generating most of the cash from financing activities in the prior-year period were proceeds from employee stock plans of \$1.4 million and \$1.8 million, respectively. Additionally, each period includes excess tax benefits recognized as an addition to the additional paid-in capital (APIC) pool of \$0.7 million and \$1.0 million, respectively. Such amounts are required to be reported as an addition to financing activities and a reduction in operating activities in the Statements of Cash Flows under the provisions of Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment.

#### **Critical Accounting Policies**

Management utilizes its technical knowledge, cumulative business experience, judgment and other factors in the selection and application of the Company's accounting policies. The accounting policies described below are considered by management to be the most critical to the presentation of the consolidated financial statements because they require the most difficult, subjective and complex judgments. Management made no changes to the Company's critical accounting policies during the six months ended June 30, 2008.

In applying the critical accounting policies described below, management reassesses its estimates each reporting period based on available information. Changes in such estimates did not have a significant impact on earnings for the three or six months ended June 30, 2008.

**Revenue Recognition.** Revenue for product sales (including hardware and consumables), which do not include any requirement for installation or training, is recognized on shipment, at which point the following criteria of SEC Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, Topic 13(A)(1) have been satisfied:

Persuasive evidence of an arrangement exists. Orders are received for all sales and sales invoices are mailed on shipment.

Delivery has occurred. Product has been transferred to the customer or the customer's designated delivery agent, at which time title and risk of loss transfers.

The vendor's price is fixed or determinable. All sales prices are fixed at the time of the sale (shipment).

Collectibility is probable. All sales are made on the basis that collection is expected in line with the Company's standard payment terms, which are consistent with industry practice in the geographies in which the Company markets its products.

A standard product sale by the Company does not require a commitment on the Company's part to provide installation, set-up or training. When such services are requested, value-added resellers generally arrange and perform the service directly with the customer, with no financial interest or obligation on the part of the Company. In the limited situations in which the Company does provide installation or training services for customers, the Company charges separately for the

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**Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

service based upon its published list prices and recognizes the associated service revenue upon the successful completion of the service.

The Company records an allowance for sales returns from its customers. The amount of the allowance is based upon historical trends, timing of new product introductions and other factors. A return policy is in place with the Company's distributors to restrict the volume of returned products, and the Company reviews the distributors' inventory to ensure compliance with the return policy.

Revenue for maintenance agreements is recognized primarily on a straight-line basis over the life of the contracts, in accordance with FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts.

Emerging Issues Task Force (EITF) Issue No. 00-21, Revenue Arrangements with Multiple Deliverables provides revenue recognition guidance for arrangements with multiple deliverables and the criteria to determine if items in a multiple deliverable agreement should be accounted for separately. The elements of the Company's sales transactions are clearly and separately stated and sufficient evidence of their fair value exists to separately account for the elements.

**Allowance for Doubtful Accounts and Sales Returns.** The Company records an allowance for doubtful accounts for potentially uncollectible receivables. The allowance is established based on a specific assessment of accounts with known collection exposure, based upon a review of the age of the receivable, the customer's payment history, the customer's financial condition and industry and general economic conditions, as well as a general assessment of collection exposure in the remaining receivable population based upon bad debt history. Actual bad debt exposure could differ significantly from management's estimates if economic conditions worsened for the Company's customers. As described above under Revenue Recognition, the Company also records an allowance for sales returns from its customers. The amount of the allowance is based upon historical trends, timing of new product introductions and other factors.

**Inventory Provisions.** The Company records provisions for inventory shrinkage and for potential excess, obsolete and slow moving inventory. The amounts of these provisions are based upon usage, historical loss trends, inventory levels, expected product lives and forecasted sales demand. Results could be materially different if demand for the Company's products decreased because of economic or competitive conditions, or if products became obsolete because of technical advancements in the industry or by the Company.

**Income Taxes.** The Company recognizes deferred tax assets for the expected future tax impact of temporary differences between book and taxable income. A valuation allowance and income tax charge are recorded when, in management's judgment, realization of a specific deferred tax asset is uncertain. Income tax expense could be materially different from actual results because of changes in management's expectations regarding future taxable income, the relationship between book and taxable income and tax planning strategies employed by the Company.

On January 1, 2007, the Company adopted FIN 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109. Prior to adoption, the Company's policy was to

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**Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

establish an accrual that reflected the probable outcome of known tax contingencies. The effects of final resolution, if any, were recognized as changes to the effective income tax rate in the period of resolution. FIN 48 requires application of a more-likely-than-not threshold to the recognition and derecognition of uncertain tax positions. Under FIN 48, once the more-likely-than-not threshold is met, the amount of benefit to be recognized is the largest amount of tax benefit that is greater than 50 percent likely of being ultimately realized upon settlement. It further requires that a change in judgment related to the expected ultimate resolution of uncertain tax positions be recognized in earnings in the period of such a change. Management recognizes a tax accrual for estimated exposures associated with uncertain tax positions and adjusts this accrual in light of changing facts and circumstances. However, due to the complexity of some of these uncertainties, the ultimate settlement may result in payments that are significantly different from management's current estimate of tax liabilities, resulting in the recognition of additional charges or benefits to income tax expense.

For the six months ended June 30, 2008, the Company recognized tax liabilities of \$48,000 and \$217,000, before reduction for the federal benefit for state and foreign income tax related amounts, for new uncertainties related to current period income tax positions and prior period income tax positions, respectively. The Company reversed during the six months ended June 30, 2008 gross tax liabilities, exclusive of interest and penalties, amounting to \$72,000 associated with income tax settlements.

**Warranty Accruals.** The Company's non-consumable products are warranted to the end-user to ensure end-user confidence in design, workmanship and overall quality. Warranty lengths vary by product type, ranging from periods of six to twelve months. Warranty covers parts, labor and other associated expenses. The Company performs the majority of warranty work, while authorized distributors and dealers also perform some warranty work. The Company records a liability for estimated future warranty claims during the warranty period. The amount of the liability is based on an analysis of historical claims experience, which includes labor, parts and freight costs and consideration of the proportion of parts that can be re-used. Also considered are the anticipated impact of product improvements, releases of new products and other factors. Claims experience could be materially different from actual results because of the introduction of new, more complex products; a change in the Company's warranty policy in response to industry trends, competition or other external forces; or manufacturing changes that could impact product quality.

**Stock-Based Compensation.** The Company implemented the fair value recognition provisions of SFAS No. 123R effective January 1, 2006 using the modified prospective method. Under this method, the Company recognizes compensation expense on a straight-line basis over the vesting period for all stock-based awards granted on or after January 1, 2006, and for previously granted awards not yet vested as of January 1, 2006. The Company recognized stock-based compensation costs of approximately \$0.3 million and \$0.5 million for the six months ended June 30, 2008 and 2007, respectively.

The Company utilizes a Black-Scholes option pricing model to estimate the fair value of each stock option award on the date of grant. The Black-Scholes model requires the input of certain assumptions that involve management judgment. Key assumptions that affect the calculation of fair value include the expected life of stock-based awards and the Company's stock price volatility. Additionally, the Company is required to estimate the expected forfeiture rate of unvested awards

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**Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

and recognize expense for only those shares expected to vest. The assumptions used in calculating the fair value of stock-based awards and the forfeiture rate of such awards reflect management's best estimates. However, circumstances may change and additional data may become available over time, which could result in changes to these assumptions that materially impact the fair value determination of future awards or their estimated rate of forfeiture. If assumptions change for future stock-based awards, the compensation expense recorded under SFAS 123R may differ significantly from the expense recorded in the current period.

See Note 2 under the Notes to Condensed Consolidated Financial Statements in this Form 10-Q for additional information on stock-based compensation.

**Impairment of Long-lived Assets.** Long-lived assets at June 30, 2008 consisted of property and equipment. In accordance with SFAS No. 144, Accounting for Impairment or Disposal of Long-Lived Assets, the Company reviews the carrying amount of its long-lived assets when events or changes in circumstances such as market value, asset utilization, physical change, legal factors or other matters indicate that the carrying amount of the assets may not be recoverable. When this review indicates the carrying amount of an asset or asset group exceeds the sum of the future undiscounted cash flows expected to be generated by the assets, the Company recognizes an asset impairment charge against operations for the amount by which the carrying amount of the impaired asset exceeds its fair value. Considerable judgment is required in the evaluation of whether certain events or circumstances lead to an indication of impairment and in the assumptions used in determining the amount and period over which future revenues are expected to be earned, related costs, terminal values and discount rates. No impairment charges were recognized by the Company during the six months ended June 30, 2008. The Company recorded charges to cost of revenues of \$60,000 during the six months ended June 30, 2007 for impairment in the carrying value of manufacturing tooling associated with the assembly of the Rimage 360i product line.

**Recently Issued Accounting Standards**

In December 2007, the FASB issued SFAS No. 141R (revised 2007), Business Combinations. SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired in the business combination. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141R becomes effective for business combinations occurring after January 1, 2009, and early adoption is prohibited.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51. SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties

other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. The provisions of SFAS No. 160 are effective for the Company beginning January 1, 2009. The Company is currently evaluating the

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**Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**

impact of adopting this pronouncement on its consolidated financial statements and related disclosures.

**Cautionary Note Regarding Forward-Looking Statements**

This report contains forward-looking statements that involve risks and uncertainties. For this purpose, any statements contained in this report that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, words such as "may," "will," "expect," "believe," "anticipate," "estimate" or "continue" or comparable terminology are intended to identify forward-looking statements. These statements by their nature involve substantial risks and uncertainties. The Company's actual results could differ significantly from those discussed in the forward-looking statements.

Factors that could cause or contribute to such differences include, but are not limited to, the following, as well as other factors not now identified: the Company's ability to keep pace with changes in technology in the computer and storage media industries as well as technology changes in the retail, medical and business services markets; increasing competition and the ability of the Company's products to successfully compete with products of competitors and newly developed media storage products; the ability of the Company's newly developed products to gain acceptance and compete against products in their markets; the significance of the Company's international operations and the risks associated with international operations including currency fluctuations, local economic health and management of these operations over long distances; the economic health of the markets from which Rimage derives its sales and, in particular, the strength of the economies within North America and Europe where the Company has averaged 94% of total sales over the past three years; the Company's ability to protect its intellectual property and to defend claims of others relating to its intellectual property; the Company's dependence upon the selling efforts of the Company's key channel partners; the Company's ability to maintain adequate inventory of products; the Company's reliance on single source suppliers; the ability of the Company's products to operate effectively with the computer products developed and to be developed by other manufacturers; the negative effect upon the Company's business from manufacturing or design defects; the effect of U.S. and international regulation; fluctuations in the Company's operating results; the Company's dependence upon its key personnel; the volatility of the price of the Company's common stock; provisions governing the Company relating to a change of control, compliance with corporate governance and securities disclosures rules and other risks, including those set forth in the Company's reports filed with the Securities and Exchange Commission, including Item 1A of Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2007. These forward-looking statements are made as of the date of this report and the Company assumes no obligation to update such forward-looking statements, or to update the reasons why actual results could differ materially from those anticipated in such forward-looking statements.

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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

The Company is exposed to market risk from foreign exchange rate fluctuations of the European Euro and Japanese Yen to the U.S. dollar as the financial position and operating results of the Company's German and Japanese subsidiaries, Rimage Europe GmbH and Rimage Japan Co., Ltd., respectively, are translated into U.S. dollars for consolidation. Resulting translation adjustments are recorded as a separate component of stockholders' equity.

The Company enters into forward exchange contracts principally to hedge intercompany receivables denominated in Euros arising from sales to its subsidiary in Germany. Gains or losses on forward exchange contracts are calculated at each period end and are recognized in net income in the period in which they arose. The Company records the fair value of its open forward foreign exchange contracts in other current assets or other current liabilities depending on whether the net amount is a gain or a loss. The Company does not utilize financial instruments for trading or other speculative purposes.

**Item 4. Controls and Procedures**

(a) Evaluation of Disclosure Controls and Procedures

The Company's Chief Executive Officer, Bernard P. Aldrich, and the Company's Chief Financial Officer, Robert M. Wolf, have evaluated the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon such evaluation, they have concluded that these disclosure controls and procedures are effective.

(b) Changes in Internal Control Over Financial Reporting

There have been no changes in internal controls over financial reporting that occurred during the fiscal quarter covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

Not Applicable.

**Item 1A. Risk Factors**

Not Applicable.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table provides certain information regarding purchases made by the Company of its common stock in the quarter ended June 30, 2008:

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| <b>Period</b>            | <b>Total Number<br/>of Shares<br/>Purchased</b> | <b>Average Price<br/>Paid Per Share</b> | <b>Total Number<br/>of<br/>Shares<br/>Purchased<br/>as Part of<br/>Publicly<br/>Announced<br/>Plan<br/>or Program</b> | <b>Maximum<br/>Number<br/>of Shares that<br/>May Yet Be<br/>Purchased<br/>Under<br/>the Plans<br/>or Programs<br/>(1)</b> |
|--------------------------|---|---|---|---|
| April 1 - April 30, 2008 | 166,500   | \$ 17.54                                | 166,500   | 806,990   |
| May 1 - May 31, 2008     | 82,300  | \$ 17.89                                | 82,300  | 724,690   |
| June 1 - June 30, 2008   |   |   |   | 724,690   |
| <b>Total</b>             | <b>248,800</b>                                  | <b>\$ 17.66</b>                         | <b>248,800</b>  | <b>724,690</b>  |

(1) On October 17, 2007, the Company's Board of Directors authorized the repurchase of up to 500,000 shares of its common stock. In February 2008, the Company's Board of Directors increased the share repurchase authorization by an additional 500,000 shares, bringing total shares authorized for repurchase to 1,000,000. Shares will be purchased at prevailing market prices in the open market or in private transactions, subject to market conditions, share price, trading volume and other factors. The repurchase program may be discontinued at any time. The Company will finance the purchase of the shares using cash on hand.

**Item 3. Defaults Upon Senior Securities**

Not Applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

The Company's Annual Meeting of Shareholders was held on May 14, 2008. Of the 9,805,737 shares outstanding and entitled to vote at the meeting, 8,902,931 shares were present either in person or by proxy. The following describes the matters considered by the Company's shareholders at the Annual Meeting, as well as the results of the votes cast at the meeting:

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- A. To elect six (6) directors of the Company to serve until the next Annual Meeting of Shareholders or until their respective successors have been elected and qualified.

| <u>Nominee</u>         | <u>In Favor</u> | <u>Withheld</u> |
|------------------------|-----------------|-----------------|
| Bernard P. Aldrich     | 8,778,731       | 124,200         |
| Lawrence M. Benveniste | 8,778,376       | 124,555         |
| Philip D. Hotchkiss    | 8,779,158       | 123,773         |
| Thomas F. Madison      | 8,707,669       | 195,262         |
| Steven M. Quist        | 8,772,820       | 130,111         |
| James L. Reissner      | 8,777,079       | 125,852         |

- B. To ratify and approve the appointment of KPMG, LLP as independent auditors for the Company for the fiscal year ending December 31, 2008.

| <u>FOR</u> | <u>AGAINST</u> | <u>ABSTAIN</u> |
|------------|----------------|----------------|
| 8,606,768  | 293,395        | 2,768          |

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#### **Item 5. Other Information**

Not Applicable.

#### **Item 6. Exhibits**

- (a) The following exhibits are included herein:

|      |   |
|------|---|
| 31.1 | Certificate of Chief Executive Officer pursuant to Rules 13a-14 and 15d-14 of the Exchange Act. |
| 31.2 | Certificate of Chief Financial Officer pursuant to Rules 13a-14 and 15d-14 of the Exchange Act. |
| 32   | Certifications pursuant to 18 U.S.C. §1350.   |

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**SIGNATURES**

In accordance with the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned thereto duly authorized.

RIMAGE CORPORATION

Registrant

Date: August 8, 2008

By: /s/ Bernard P. Aldrich  
Bernard P. Aldrich  
Director, Chief Executive Officer,  
and President  
(Principal Executive Officer)

Date: August 8, 2008

By: /s/ Robert M. Wolf  
Robert M. Wolf  
Chief Financial Officer  
(Principal Financial Officer)  
(Principal Accounting Officer)

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