

BITSTREAM INC
Form 10-Q
November 14, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 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 September 30, 2006

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
(State or other jurisdiction of

incorporation or organization)

245 First Street, 17th Floor, Cambridge, Massachusetts 02142-1270

(Address of principal executive offices and zip code)

04-2744890
(I.R.S. Employer

Identification No.)

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(617) 497-6222

(Registrant's telephone number, including area code)

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

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

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

On November 9, 2006, there were 9,264,503 shares of Class A Common Stock, par value \$0.01 per share issued, including 11,809 shares issued and designated as treasury shares, and no shares of Class B Common Stock, par value \$0.01 per share, issued or outstanding.

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BITSTREAM INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT PER-SHARE AMOUNTS)
(Unaudited)

| | September 30, 2006 | December 31, 2005 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 9,819 | \$ 5,464 |
| Accounts receivable, net of allowance of \$70 and \$38 at September 30, 2006 and December 31, 2005, respectively | 1,747 | 1,663 |
| Short-term investments, prepaid expenses and other current assets | 354 | 341 |
| Total current assets | 11,920 | 7,468 |
| Property and equipment, net | 318 | 315 |
| Other long-term assets: | | |
| Restricted cash | 200 | 200 |
| Goodwill | 727 | 727 |
| Intangible assets, net | 100 | 125 |
| Total other assets | 1,027 | 1,052 |
| Total assets | \$ 13,265 | \$ 8,835 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,021 | \$ 664 |
| Accrued expenses | 855 | 1,191 |
| Deferred revenue | 1,450 | 1,085 |
| Total current liabilities | 3,326 | 2,940 |
| Deferred rent | 190 | 194 |
| Total liabilities | 3,516 | 3,134 |
| Commitments and contingencies (Note 5) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value, Authorized 6,000 shares, Issued and outstanding- 0 at September 30, 2006 and December 31, 2005 | | |
| Common stock, \$0.01 par value Authorized - 30,500 shares Issued 9,263 and 8,810 and outstanding 9,251 and 8,684 at September 30, 2006 and December 31, 2005, respectively | 93 | 88 |
| Additional paid-in capital | 34,005 | 32,892 |
| Accumulated deficit | (24,315) | (26,919) |
| Treasury stock, at cost; 12 and 126 shares at September 30, 2006 and December 31, 2005, respectively | (34) | (360) |
| Total stockholders' equity | 9,749 | 5,701 |

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| | | |
|--|-----------|----------|
| Total liabilities and stockholders' equity | \$ 13,265 | \$ 8,835 |
|--|-----------|----------|

The accompanying notes are an integral part of these 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, | | Nine Months Ended September 30, | |
|---|-------------------------------------|---------------|------------------------------------|---------------|
| | 2006 | 2005 | 2006 | 2005 |
| Revenue: | | | | |
| Software licenses | \$ 4,241 | \$ 3,213 | \$ 12,218 | \$ 9,209 |
| Services | 912 | 618 | 2,482 | 1,826 |
| Total revenue | 5,153 | 3,831 | 14,700 | 11,035 |
| Cost of revenue: | | | | |
| Software licenses | 1,544 | 1,053 | 4,420 | 3,139 |
| Services | 395 | 270 | 1,129 | 871 |
| Cost of revenue | 1,939 | 1,323 | 5,549 | 4,010 |
| Gross profit | 3,214 | 2,508 | 9,151 | 7,025 |
| Operating expenses: | | | | |
| Marketing and selling | 769 | 742 | 2,372 | 2,183 |
| Research and development | 1,066 | 943 | 3,216 | 2,924 |
| General and administrative | 528 | 493 | 1,550 | 1,679 |
| Total operating expenses | 2,363 | 2,178 | 7,138 | 6,786 |
| Operating income | 851 | 330 | 2,013 | 239 |
| Legal fee reimbursement | | | 464 | |
| Interest and other income, net | 93 | 14 | 154 | 40 |
| Total other income and expense | 93 | 14 | 618 | 40 |
| Income before provision for income taxes | 944 | 344 | 2,631 | 279 |
| Provision for income taxes | (9) | 32 | 27 | 33 |
| Net income | \$ 953 | \$ 312 | \$ 2,604 | \$ 246 |
| Basic net income per share | \$ 0.10 | \$ 0.04 | \$ 0.29 | \$ 0.03 |
| Diluted net income per share | \$ 0.09 | \$ 0.03 | \$ 0.25 | \$ 0.03 |
| Basic weighted average shares outstanding | 9,158 | 8,676 | 8,978 | 8,655 |
| Diluted weighted average shares outstanding | 10,575 | 9,640 | 10,547 | 9,478 |

The accompanying notes are an integral part of these 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, | 2005 |
| | 2006 | 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 2,604 | \$ 246 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 151 | 138 |
| Amortization | 46 | 60 |
| Share based compensation. | 199 | |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (84) | (204) |
| Prepaid expenses and other assets | (13) | 20 |
| Accounts payable | 357 | 298 |
| Accrued expenses | (336) | (335) |
| Deferred revenue | 365 | 229 |
| Deferred rent | (4) | (4) |
| Net cash provided by operating activities | 3,285 | 448 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment, net | (154) | (175) |
| Additions to intangible assets | (21) | (30) |
| Restricted cash | | 50 |
| Net cash used in by investing activities | (175) | (155) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from exercise of stock options/warrants | 1,245 | 101 |
| Net cash provided by financing activities | 1,245 | 101 |
| Net Increase in Cash and Cash Equivalents | 4,355 | 394 |
| Cash and Cash Equivalents, beginning of period | 5,464 | 4,405 |
| Cash and Cash Equivalents, end of period | \$ 9,819 | \$ 4,799 |

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

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Operations and Significant Accounting Policies

Bitstream Inc., together with its subsidiaries (collectively, Bitstream or the Company), enables customers worldwide to render high-quality text, browse the web on wireless devices, select from the largest collection of fonts online, and customize documents over the Internet. Our core competencies include fonts, font technology, browsing technology, and publishing technology. Visit Bitstream on the Web at <http://www.bitstream.com>. Information included on our website is not incorporated in this Form 10-Q.

We are subject to risks common to technology-based companies, including dependence on key personnel, rapid technological change, competition from alternative product offerings and larger companies, and challenges to the development and marketing of commercial products and services. We have also experienced net losses in prior years and as of September 30, 2006 have an accumulated deficit of \$24 million.

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

(a) Basis of Presentation

Our condensed consolidated financial statements presented herein, without audit, have been prepared pursuant to the rules of the Securities and Exchange Commission (the SEC) for quarterly reports on Form 10-Q and do not include all of the information and footnote disclosures required by generally accepted accounting principles. The balance sheet information at December 31, 2005 has been derived from our audited consolidated financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. These statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2005 included in our Annual Report on Form 10-K, which was filed with the SEC on March 30, 2006. The condensed consolidated balance sheet as of September 30, 2006, the condensed consolidated statements of operations for the three and nine month periods ended September 30, 2006 and 2005, and the condensed consolidated statement of cash flows for the nine months ended September 30, 2006 and 2005, 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, 2006 may not necessarily be indicative of the results to be expected for the year ending December 31, 2006.

(b) Revenue Recognition (in thousands)

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

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

We receive and recognize licensing fees and royalty revenue from: (1) Original Equipment Manufacturer (OEM) and Independent Software Vendor (ISV) customers for fonts and 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, training 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.

Certain OEM and ISV customers pay royalties only upon the sublicensing of our products to end-users. Revenue in such transactions is recognized in the period when sublicenses to end users are reported to us by our OEM or ISV customers. Revenue from guaranteed minimum royalty licenses is recognized 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. 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, net of estimated returns and allowances, 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 the ThunderHawk 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 revenue is recognized at the net amount received by Bitstream and for the three months ended September 30, 2006 and 2005 was \$5 and \$4, respectively. Referral revenue for the nine months ended September 30, 2006 and 2005 was \$16 and \$12, 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.

We recognize revenue under multiple-element arrangements using the residual method when vendor-specific objective evidence 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. Accordingly, software license revenue is recognized under the residual method in arrangements in which software is licensed with consulting, training or other services.

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 each agreement.

Deferred revenue includes unearned software maintenance revenue and advance billings under software development contracts and page layout technology licenses.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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 expenses related to warranty claims.

(c) Stock-Based Compensation

Effective January 1, 2006, we adopted the provisions of, and account for stock-based compensation in accordance with, the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 123 revised 2004 (SFAS 123R), *Share-Based Payment* which replaced Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*. 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 elected the modified-prospective method, under which prior periods are not revised for comparative purposes. The valuation provisions of SFAS 123R apply to new grants, to grants that were outstanding as of the effective date, and to grants that are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service periods using the compensation cost estimated for the SFAS 123 pro forma disclosures.

The adoption of SFAS 123R had a material impact on our consolidated financial position, results of operations and cash flows. See Note 3 for further information regarding our stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods as if we had recorded stock-based compensation expense.

(d) Income Taxes

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

The tax provision for the three months ended September 30, 2006 included an \$(11) benefit in U.S. Federal income tax due to a refund of alternative minimum tax and \$2 of foreign withholding taxes. The tax provision for the nine months ended September 30, 2006 included \$23 of expense for U.S. Federal alternative minimum tax and \$4 of foreign withholding taxes. The Company did not have a provision for U.S. Federal tax during the same periods ended September 30, 2005 due to taxable losses and did not record a provision for state income taxes during any of these periods due to taxable losses and loss carry forwards. Our tax provision for the three and nine month periods ended September 30, 2005 consisted of foreign withholding taxes of \$32 and \$33, respectively. Foreign taxes vary with OEM license royalties from customers in countries who are party to tax conventions with the United States including Korea and Poland.

Table of Contents**BITSTREAM INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (Continued)****(e) Cash and Cash Equivalents**

As of September 30, 2006, cash and cash equivalents included bank deposits and money market instruments. We consider all highly liquid investments with original maturities of three months or less at the time of acquisition to be cash equivalents and record such investments at cost, which approximates market value.

(f) Property and Equipment (in thousands)

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

| | September 30, | December 31, |
|--|---------------|--------------|
| | 2006 | 2005 |
| Equipment and computer software | \$ 2,949 | \$ 2,875 |
| Purchased software | 438 | 419 |
| Furniture and fixtures | 399 | 380 |
| Leasehold improvements | 105 | 81 |
| | 3,891 | 3,755 |
| Less Accumulated depreciation and amortization | 3,573 | 3,440 |
| Property and equipment, net | \$ 318 | \$ 315 |

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

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

Depreciation expense for the three months ended September 30, 2006 and 2005 was \$50 and \$48, respectively. Depreciation expense for the nine months ended September 30, 2006 and 2005 was \$151 and \$138, respectively.

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

Financial instruments that potentially expose us to concentrations of credit risk consist primarily of cash and cash equivalents and trade accounts receivable. We place a majority of our cash investments in one highly-rated financial institution, the balance of which may exceed federally insured deposit limits. We have not experienced significant losses related to receivables from any individual customers or groups of customers in any specific industry or by geographic area. Due to these factors, no additional credit risk beyond amounts provided for collection losses is believed by us to be inherent in our accounts receivable. At September 30, 2006, one customer accounted for 35% of our accounts receivable. We do not have any off-balance sheet risks as of September 30, 2006. At December 31, 2005, two customers each accounted for 17% and 11% of our accounts receivable, respectively. No single customer accounted for 10% or greater of our revenue for the three and nine month periods ended September 30, 2006 or September 30, 2005.

Table of Contents**BITSTREAM INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (Continued)****(h) Goodwill and other intangible assets (in thousands)**

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

The components of the Company's amortized intangible assets follow:

| | September 30, 2006 | | | December 31, 2005 | | |
|-------------------|--------------------|-----------------|---------------|-------------------|-----------------|---------------|
| | Gross | | Net | Gross | | Net |
| | Carrying | Accumulated | | Carrying | Accumulated | |
| | Amount | Amortization | Carrying | Amount | Amortization | Amount |
| Marketing-related | \$ 76 | \$ (75) | \$ 1 | \$ 76 | \$ (72) | \$ 4 |
| Technology-based | 532 | (433) | 99 | 511 | (390) | 121 |
| Total | \$ 608 | \$ (508) | \$ 100 | \$ 587 | \$ (462) | \$ 125 |

Amortization expense for finite-lived intangible assets for the three months ended September 30, 2006 and 2005 was \$12, and \$20, respectively. Amortization expense for finite-lived intangible assets for the nine months ended June 30, 2006 and 2005 was \$46, and \$60, respectively. Estimated amortization for the five succeeding years is as follows:

| Estimated Amortization Expense: | |
|---------------------------------|---------------|
| 2006, remainder | \$ 12 |
| 2007 | 40 |
| 2008 | 27 |
| 2009 | 12 |
| 2010 | 6 |
| 2011 | 3 |
| | \$ 100 |

(i) Comprehensive Income

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

(j) Recently Issued Accounting Standards

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This accounting standard will be effective for us beginning January 1, 2007. We are currently assessing the provisions of FIN 48.

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

In September 2006, the Securities and Exchange Commission (the SEC) Staff issued Staff Accounting Bulletin No. 108 (SAB 108) addressing how the effects of prior-year uncorrected financial statement misstatements should be considered in current-year financial statements. SAB 108 requires registrants to quantify misstatements using both balance-sheet and income-statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relative quantitative and qualitative factors. SAB 108 does not change the SEC staff's previous guidance in Staff Accounting Bulletin No. 99 on evaluating the materiality of misstatements. SAB 108 addresses the mechanics of correcting misstatements that include the effects from prior years. Additionally, SAB 108 requires registrants to apply the new guidance for the first time that a registrant identifies material errors in existence at the beginning of the first fiscal year ending after November 15, 2006 by correcting those errors through a one-time cumulative effect adjustment to beginning-of-year retained earnings. We do not anticipate the adoption of SAB 108 to have a material effect on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), which establishes a comprehensive framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. Specifically, SFAS No. 157 sets forth a definition of fair value, and establishes a hierarchy prioritizing the inputs to valuation techniques, giving the highest priority to quoted prices in active markets for identical assets and liabilities and the lowest priority to unobservable inputs. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The provisions of SFAS No. 157 are generally required to be applied on a prospective basis. We do not expect this standard to have a material effect on our financial position, results of operations or cash flows.

2) Income Per Share (in thousands)

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

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2006 | September 30, 2005 | September 30, 2006 | September 30, 2005 |
| Basic weighted average shares outstanding | 9,158 | 8,676 | 8,978 | 8,655 |
| Dilutive effect of options | 1,405 | 964 | 1,555 | 823 |
| Dilutive effect of warrants | 12 | | 14 | |
| Shares used to compute diluted net income per share | 10,575 | 9,640 | 10,547 | 9,478 |

In addition, there were warrants and options outstanding to purchase 216 shares for the three and nine month periods ended September 30, 2006, and 419 and 542 shares for the three and nine month periods ended September 30, 2005, respectively, that were not included in the potential common share computations because their exercise prices were greater than the average market price of our common stock.

Table of Contents**BITSTREAM INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (Continued)****(3) Stock-based Compensation Plans and Stock-based Compensation Expense (in thousands, except per share amounts)****(a) Stock-based Compensation Expense**

Effective January 1, 2006, we adopted the provisions of, and account for stock-based compensation in accordance with, the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 123 revised 2004 (SFAS 123R), *Share-Based Payment* which replaced Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*. 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 elected the modified-prospective method, under which prior periods are not revised for comparative purposes. The valuation provisions of SFAS 123R apply to new grants, to grants that were outstanding as of the effective date, and to grants that are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost estimated for the SFAS 123 pro forma disclosures.

Prior to January 1, 2006, we accounted for share-based compensation to employees in accordance with Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. We also followed the disclosure requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*. We have elected to adopt the modified prospective transition method as provided by SFAS No. 123(R) and, accordingly, financial statement amounts for the periods prior to January 1, 2006 presented in this Form 10-Q have not been restated to reflect the fair value method of expensing share-based compensation.

We currently estimate 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 our stock over the option's expected term, the risk-free interest rate over the option's expected term, and our expected annual dividend yield. We do not anticipate paying any cash dividends in the foreseeable future and therefore use an expected dividend yield of zero in the option valuation model. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. We believe that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of our stock options. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards. These amounts, and the amounts applicable to future quarters, are also subject to future quarterly adjustments based upon a variety of factors, which include but are not limited to, the issuance of new options. The following table summarizes the assumptions we utilized for grants of options in the three and nine month periods ended September 30, 2006:

| | Three Months Ended | |
|--------------------------|---------------------------|---|
| | September 30, 2006 | Nine Months Ended September 30, 2006 |
| Risk-free interest rates | 4.90% | 4.90% |
| Expected dividend yield | None | None |
| Expected term | 5 Years | 5 Years |
| Expected volatility | 92.05% | 92.05% |

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

All options granted have a contractual ten year term. All options granted vest in equal installments on the first, second, third, and fourth year anniversaries over a four year period of continuous employee service. 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 5 years, the expected term of the option. We use historical exercise, forfeiture, and cancellation information to determine expected term and forfeiture rates.

As a result of the adoption of SFAS No. 123R, our results for the three and nine month periods ended September 30, 2006 include \$83 and \$199, respectively, of stock-based compensation within the applicable expense classification where we report the option holders' compensation cost. The following table presents stock-based compensation expense included in our condensed consolidated statement of operations:

| | Three Months Ended | Nine Months Ended |
|---|-----------------------|-----------------------|
| | September 30, 2006 | September 30, 2006 |
| Cost of revenue- software licenses | \$ | \$ |
| Cost of revenue- services | 4 | 11 |
| Marketing and selling | 20 | 56 |
| Research and development | 16 | 28 |
| General and administrative | 43 | 104 |
| Share-based compensation expense before tax | 83 | 199 |
| Income tax benefit | | |
| Net compensation expense | \$ 83 | \$ 199 |

Prior to fiscal 2006, no material compensation cost related to share-based awards to employees was recognized in our consolidated statement of operations.

No compensation cost has been recognized for employee share-based awards for the three and nine month periods ended September 30, 2005. Had compensation cost been determined based on the fair value at the grant dates, our net loss would have been the pro forma amounts indicated in the table below.

| | Three Months Ended | Nine Months Ended |
|--|-----------------------|-----------------------|
| | September 30, 2005 | September 30, 2005 |
| Net income (loss) | | |
| As reported | \$ 312 | \$ 246 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all grants, net of related tax effects | 92 | 292 |
| Pro forma | \$ 220 | \$ (46) |
| Basic net income (loss) per share: | | |
| As reported | \$ 0.04 | \$ 0.03 |
| Pro forma | \$ 0.03 | \$ (0.01) |

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Diluted net income (loss) per share:

| | | | | |
|-------------|----|------|----|--------|
| As reported | \$ | 0.03 | \$ | 0.03 |
| Pro forma | \$ | 0.02 | \$ | (0.01) |

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

For purposes of computing pro forma net income (loss), we estimated the fair value of all option or warrant grants outstanding to employees as of September 30, 2005 using the Black Scholes option pricing model prescribed by SFAS No. 123. Assumptions used and weighted average information are as follows:

| | Three Months Ended September 30, 2005 * | Nine Months Ended September 30, 2005 |
|--------------------------|--|---|
| Risk-free interest rates | | 3.69% to 3.76% |
| Expected dividend yield | | |
| Expected term | | 5 Years |
| Expected volatility | | 100.7% to 104.5% |

* No grants were made during the three months ended September 30, 2005.

(b) Stock-based Compensation Plans:

All existing stock-based compensation plans adopted by our Board of Directors as of September 30, 2006 authorized grants of warrants, incentive stock options and nonqualified stock options. The aggregate intrinsic value of outstanding options and warrants as of September 30, 2006 was \$5,193 of which \$4,265 related to exercisable options and warrants. The intrinsic value of options exercised in the three and nine month periods ended September 30, 2006 was \$245 and \$1,179, respectively, and the intrinsic value of options that vested during the periods was \$99 and \$249, respectively. The intrinsic value is the difference between the market value of the shares on the exercise date and the exercise price of the option. The total non-cash compensation cost after forfeiture assumptions not yet recognized as of September 30, 2006 related to non-vested awards was \$727, which will be recognized over a weighted-average period of 1.70 years. During the three and nine month periods ended September 30, 2006, there were none and four shares, respectively, forfeited with a weighted average grant date fair value of \$0 and \$10, respectively. The weighted average remaining contractual life for options and warrants exercisable at September 30, 2006 was 4.19 years.

Our Board of Directors has adopted several stock plans under which we are authorized to grant restricted stock, warrants, incentive stock options and nonqualified stock options to purchase shares of Bitstream Inc. Class A Common Stock. Options granted under these plans are exercisable at such price as shall be determined by the Board of Directors at the time of grant which, in the case of incentive stock options, shall be no less than the fair market value of the shares on the date of grant and expire no later than 10 years from the date of grant. Non-qualified options and warrants are generally granted at fair market value. All options and warrants granted under these plans through June 30, 2006 vest annually over a three-year period assuming continued service and all options and warrants granted subsequent to June 30, 2006 vest annually over a four-year period assuming continued service. In addition, the plans provide that options granted thereunder, subject to future vesting, shall immediately vest upon the occurrence of certain events, such as the sale of all or substantially all of the assets of the Company or a change in control of the Company. As of September 30, 2006, we have available for issuance 1,952 shares of Class A Common Stock pursuant to the various stock plans. The Company may issue common stock from previously authorized but unissued shares or from previously issued shares that are held in treasury to satisfy option exercises.

On February 11, 2000, the Board of Directors adopted the Pageflex, Inc. and MyFonts.com, Inc. 2000 Stock Plans. Under these 2000 Stock Plans, we are authorized to grant warrants, incentive stock options and nonqualified stock options to purchase up to 3,000 shares of Common Stock in each of these two subsidiaries. Options granted under these 2000 Stock Plans are exercisable at such price as shall be determined by the Board of Directors at the time of grant which, in the case of incentive stock options, shall be no less than the fair market value of the shares on the date of grant and expire no later than 10 years from the date of grant. In addition, the 2000 Stock Plans provide that options granted thereunder, subject to future vesting, shall immediately vest upon the occurrence of certain events, such as the sale of all or substantially all of the assets of the subsidiary or a change in control of the subsidiary.

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

All options granted under these 2000 Stock Plans through September 30, 2006 have vested annually over a three-year period. As of September 30, 2006, we have available for issuance 1,827 and 1,375 shares of Pageflex, Inc. and MyFonts.com, Inc. Common Stock, respectively, pursuant to the 2000 Stock Plans. We have not granted options to purchases shares in our subsidiaries since 2001 and we do not intend to grant, any additional options under these two Stock Plans.

Stock Options:

Stock option activity under all Bitstream, Inc. stock option plans for the nine months ended September 30, 2006 and the year ended December 31, 2005 is as follows:

| | Number of Options | Exercise Price | Weighted Average Remaining Contractual Term (In years) | Aggregate Intrinsic Value |
|--|-------------------------|-------------------|--|---------------------------------|
| Outstanding, December 31, 2004 | 2,729 | \$ 2.23 | 5.18 | \$ 5,548 |
| Exercised | (45) | 2.30 | | (95) |
| Canceled | (29) | 4.74 | | (130) |
| Forfeited | (5) | 2.45 | | (9) |
| Granted | 54 | 2.45 | | 92 |
| Outstanding, December 31, 2005 | 2,704 | 2.21 | 4.27 | 5,406 |
| Exercised | (566) | 2.20 | | (1,179) |
| Canceled | | | | |
| Forfeited | (4) | 2.55 | | (10) |
| Granted | 213 | 4.45 | | 694 |
| Outstanding, September 30, 2006 | 2,347 | 2.41 | 4.29 | \$ 4,911 |
| Exercisable, September 30, 2006 | 1,989 | \$ 2.21 | 3.43 | \$ 3,982 |
| Weighted average fair value of options granted during the nine months ended September 30, 2006 | | | | \$ 3.26 |

| Range of Exercise Prices | Weighted Average Remaining Contractual | Options Outstanding | | Options Exercisable | |
|-----------------------------|--|---------------------|---------------------------------------|---------------------|---------------------------------------|
| | Life in Years | Number | Weighted Average Exercise Price | Number | Weighted Average Exercise Price |
| \$ 1.34 - \$ 1.38 | 1.97 | 50 | \$ 1.37 | 50 | \$ 1.37 |
| 1.50 - 2.03 | 3.11 | 1,574 | 1.81 | 1,506 | 1.82 |
| 2.34 - 3.13 | 6.67 | 230 | 2.73 | 153 | 2.73 |
| 3.96 - 4.94 | 7.19 | 490 | 4.27 | 277 | 4.13 |
| 8.81 - 8.81 | 3.37 | 3 | 8.81 | 3 | 8.81 |
| \$ 1.34 - \$ 8.81 | 4.29 | 2,347 | \$ 2.41 | 1,989 | \$ 2.21 |

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Stock options outstanding and exercisable at September 30, 2006 for the Pageflex, Inc. and MyFonts.com, Inc. Common Stock, were 1,171 and 1,625, respectively.

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

5) Commitments and Contingencies, (in thousands):

Lease commitments

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

Royalties

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

Guarantees

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

Legal Actions

On June 24, 2003, Monotype Imaging, Inc. (formerly Agfa Monotype Corporation) and International Typeface Corporation filed a complaint in the U.S. District Court for the Northern District of Illinois Eastern Division claiming that we, through our TrueDoc software, infringed trademarks and copyrights and violated the Digital Millennium Copyright Act. A judge of the U.S. District Court for the Northern District of Illinois Eastern Division ruled in our favor on all counts. In her opinion issued on July 12, 2005, the Judge found that we were not liable under any claims of contributory infringement, contributory trademark infringement, or infringement under the Digital Millennium Copyright Act. Previously, on April 21, 2005, the court held that we were not liable under claims for direct copyright or trademark infringement or for vicariously infringing Monotype Imaging, Inc.'s and International Typeface Corporation's copyrights. Monotype Imaging, Inc. subsequently filed a Notice of Appeal with the court. On May 17, 2006 the U.S. District Court for the Northern District of Illinois in connection with the TrueDoc lawsuit awarded Bitstream approximately \$463,500 for legal fees, costs and expenses. Monotype Imaging, Inc. and International Typeface Corporation agreed to pay the full amount of the award and dismiss their appeal if Bitstream agreed not to appeal the Court's award set forth in the Court's May 17, 2006 Order. Bitstream accepted the proposal, received full payment and the case was terminated.

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

From time to time, in addition to the infringement case identified above, we are subject to legal proceedings and claims in the ordinary course of business, including claims of infringement of third-party patents and other intellectual property rights, commercial, employment and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. This provision is reviewed at least quarterly. As of September 30, 2006 no liability was recorded. Litigation is inherently unpredictable and it is possible that our financial position, cash flows, or results of operations could be materially affected in any particular period by the resolution of any such contingencies or the costs involved in seeking the resolution of any such contingencies.

6) Geographical Reporting (in thousands):

We attribute revenues to different geographical areas on the basis of the location of the customer. All of our product sales for the three and nine month periods ended September 30, 2006 and 2005 were shipped from our headquarters located in the United States. Revenues by geographic area are as follows:

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2006 | September 30, 2005 | September 30, 2006 | September 30, 2005 |
| *Revenue: | | | | |
| United States | \$ 4,250 | \$ 3,116 | \$ 12,455 | \$ 8,650 |
| Canada | 498 | 28 | 783 | 651 |
| United Kingdom (UK) | 128 | 108 | 314 | 503 |
| Korea | 5 | 239 | 14 | 244 |
| Other (Countries less than 5% individually, by Region) | | | | |
| Europe, excluding UK | 224 | 106 | 776 | 547 |
| Asia, excluding Korea | 42 | 169 | 329 | 332 |
| Other | 6 | 65 | 29 | 108 |
| Total revenue | \$ 5,153 | \$ 3,831 | \$ 14,700 | \$ 11,035 |

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

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PART 1, ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

OVERVIEW

Bitstream Inc. was incorporated in the State of Delaware in 1981. Bitstream Inc. (together with its subsidiaries, Bitstream or the Company) is a software development company that makes communications compelling. We enable our customers worldwide to render high-quality text, browse the web on wireless devices, select from the largest collection of fonts online, and customize documents over the Internet. Our core competencies include fonts and font technology, browsing technology, and publishing technology.

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

CRITICAL ACCOUNTING POLICIES

We incorporate by reference the section Management's Discussion and Analysis of Financial Condition and Results of Operation Critical Accounting Policies of our Annual Report on Form 10-K for the year ended December 31, 2005 filed on March 30, 2006. No changes have been made to these policies since December 31, 2005, except for the adoption of SFAS No. 123(R) in the first quarter of 2006. This standard requires that all share-based payments to employees be recognized in the statements of operations based in their fair values. We have used the Black-Scholes model to determine the fair value of our stock option awards. Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating stock price volatility and employee stock option exercise behaviors. If actual results differ significantly from these estimates, stock-based compensation expense and the Company's results of operations could be materially impacted. As stock-based compensation expense recognized in the condensed consolidated statements of operations is based on awards that ultimately are expected to vest, the amount of expense has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. If factors change and we employ different assumptions in the application of SFS No. 123(R), the compensation expense that we record in future periods may differ significantly from what we have recorded in the current period.

We adopted the modified prospective transition method provided for under SFAS No. 123(R) and consequently have not adjusted results from the prior years. Under the modified transition method, compensation costs associated with awards for the three months and nine months ended September 30, 2006 now include the quarterly expense relating to the remaining unvested awards granted prior to December 31, 2005 and the quarterly expense related to any awards issued subsequent to December 31, 2005. The Company recognizes the expense using the straight-line attribution method.

Table of Contents**FORWARD LOOKING STATEMENTS**

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended (the Securities Act) and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward-looking statements generally are identified by the words believes , project , expects , anticipates , estimates , intends , strategy , plan , may , will , will likely result , and similar expressions. Investors are cautioned that forward-looking statements are inherently uncertain. Actual performance and results of operations may differ materially from those projected or suggested in the forward-looking statements due to certain risks and uncertainties, including, without limitation, market acceptance of our products, competition and the timely introduction of new products. Additional information concerning certain risks and uncertainties that would cause actual results to differ materially from those projected or suggested in the forward-looking statements is contained in our filings with the Securities and Exchange Commission (SEC), including those risks and uncertainties discussed under the Forward Looking Statements section in our Annual Report filed with the SEC on Form 10-K on March 30, 2006. The forward-looking statements contained herein represent our judgment as of the date of this report, and we caution readers not to place undue reliance on such statements. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

RESULTS OF OPERATIONS (in thousands, except percentages)**Gross Profit:**

| | Three Months Ended September 30, | | | | | |
|------------------------|----------------------------------|--------------|----------|--------------|----------|----------------|
| | 2006 | % of Revenue | 2005 | % of Revenue | Dollars | Change Percent |
| Revenue | | | | | | |
| Software licenses | \$ 4,241 | 82.3% | \$ 3,213 | 83.9% | \$ 1,028 | 32.0% |
| Services | 912 | 17.7 | 618 | 16.1 | 294 | 47.6 |
| Total revenue | 5,153 | 100.0 | 3,831 | 100.0 | 1,322 | 34.5 |
| Cost of Revenue | | | | | | |
| Software licenses | 1,544 | 36.4 | 1,053 | 32.8 | 491 | 46.6 |
| Services | 395 | 43.3 | 270 | 43.7 | 125 | 46.3 |
| Total cost of revenue | 1,939 | 37.6 | 1,323 | 34.5 | 616 | 46.6 |
| Gross Profit | \$ 3,214 | 62.4% | \$ 2,508 | 65.5% | \$ 706 | 28.1% |

| | Nine Months Ended September 30, | | | | | |
|------------------------|---------------------------------|--------------|----------|--------------|----------|----------------|
| | 2006 | % of Revenue | 2005 | % of Revenue | Dollars | Change Percent |
| Revenue | | | | | | |
| Software licenses | \$ 12,218 | 83.1% | \$ 9,209 | 83.5% | \$ 3,009 | 32.7% |
| Services | 2,482 | 16.9 | 1,826 | 16.5 | 656 | 35.9 |
| Total revenue | 14,700 | 100.0 | 11,035 | 100.0 | 3,665 | 33.2 |
| Cost of Revenue | | | | | | |
| Software licenses | 4,420 | 36.2 | 3,139 | 34.1 | 1,281 | 40.8 |

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| | | | | | | |
|-----------------------|-----------------|--------------|-----------------|--------------|-----------------|--------------|
| Services | 1,129 | 45.5 | 871 | 47.7 | 258 | 29.6 |
| Total cost of revenue | 5,549 | 37.7 | 4,010 | 36.3 | 1,539 | 38.4 |
| Gross Profit | \$ 9,151 | 62.3% | \$ 7,025 | 63.7% | \$ 2,126 | 30.3% |

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License revenue from direct sales, which includes e-commerce sales, increased \$463 or 20.5% to \$2,724 for the three months ended September 30, 2006 as compared to \$2,261 for the three months ended September 30, 2005, and increased \$1,837 or 29% to \$8,166 for the nine months ended September 30, 2006 as compared to \$6,329 for the nine months ended September 30, 2005. License revenue from resellers increased \$89, or 41.2%, to \$305 for the three months ended September 30, 2006 as compared to \$216 for the three months ended September 30, 2005, and increased \$283 or 33.1% to \$1,137 for the nine months ended September 30, 2006 as compared to \$854 for the nine months ended September 30, 2005. License revenue from OEMs and ISVs increased \$476, or 64.7%, to \$1,212 for the three months ended September 30, 2006 as compared to \$736 for the three months ended September 30, 2005, and increased \$889, or 43.9%, to 2,915 for the nine months ended September 30, 2006 as compared to \$2,026 for the nine months ended September 30, 2005. The increases in direct and reseller revenue were due primarily to increases in the volume and variety of fonts and publishing products licensed during the first nine months of 2006. The increase in OEM and ISV revenue was due to an increase in new licenses, as well as license renewals and royalties received under existing license agreements due to increases in reported unit shipments by certain OEM customers. We believe that new customer acquisition, current customers adding licenses for existing and new products and additional unit shipments reported by OEM customers will result in increased revenue for the remainder of 2006 as compared to 2005.

Services revenue increased \$294, or 47.6%, to \$912 for the three months ended September 30, 2006 as compared to \$618 for the three months ended September 30, 2005, and increased \$656 or 35.9% to \$2,482 for the nine months ended September 30, 2006 as compared to \$1,826 for the nine months ended September 30, 2005. The increase in revenue from services was primarily due to increases in maintenance contracts associated with our publishing product line. These increases were primarily driven by increases in our customer base and customer demand for consulting and design services. We believe that our overall services revenue during 2006 will continue to exceed the level attained during 2005.

We recognize license revenue from direct sales and from licensing our products and products from third parties including e-commerce sales made via our websites, from licensing agreements with OEMs and ISVs, and from the resale of our products through various resellers. We recognize reseller revenue, if collection is probable, upon notification from the reseller that it has sold the product or, if for a physical product, upon delivery of the software. E-commerce sales include revenue from the licensing of Bitstream fonts and font technology, licensing of the ThunderHawk browser, licensing of fonts and font technology developed by third parties and from fees received from referring customers to other sites for which we have referral agreements. Referral income for the three months ended September 30, 2006 and 2005 was \$5 and \$4, respectively. Referral income for the nine months ended September 30, 2006 and 2005 was \$16 and \$12, respectively. There are minimal costs associated with referral revenue, and such costs primarily represent the time to load copies of the fonts provided by each participating foundry to the MyFonts.com database. We expense those costs as incurred.

The increase in cost of license revenue for the three and nine month periods ended September 30, 2006 as compared to the same periods ended September 30, 2005 was due to increased royalty, shipping, and credit card processing expenses attributable to increased sales across all of our product lines including increases of \$433 and \$1,155 in connection with increased e-commerce sales for the three and nine month periods ended September 30, 2006, respectively. We expect the cost of license revenue as a percentage of revenue for 2006 will approximate that of the first nine months of 2006, though the results may vary based upon the mix of products sold during the remainder of the year.

The increase in cost of services revenue for the three and nine month periods ended September 30, 2006 as compared to the same periods ended September 30, 2005 was due to an increase in customer consulting resources and support personnel and related expenses which increased costs attributable to the publishing product line by \$112 and \$288 for the three and nine month periods ended September 30, 2006, respectively. Total cost of services decreased as a percentage of services revenue for the three and nine month periods ended September 30, 2006 as compared to the same periods in 2005. We have generated increased services revenue from the infrastructure that we began to build prior to the first quarter of 2005 which is contributing to the decrease in costs as a percentage of revenue. We expect the cost of services will increase during the remainder of 2006 as we continue to invest in our infrastructure so as to be able to more efficiently provide these services.

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

Operating Expenses:

| | Three Months Ended September 30, | | | | | |
|----------------------------|----------------------------------|---------|----------|---------|---------|---------|
| | 2006 | Revenue | 2005 | Revenue | Dollars | Percent |
| | % of | % of | % of | % of | Change | |
| Marketing and selling | \$ 769 | 14.9% | \$ 742 | 19.4% | \$ 27 | 3.6% |
| Research and development | 1,066 | 20.7 | 943 | 24.6 | 123 | 13.0 |
| General and administrative | 528 | 10.2 | 493 | 12.9 | 35 | 7.1 |
| Total operating expenses | \$ 2,363 | 45.9% | \$ 2,178 | 56.9% | \$ 185 | 8.5% |

| | Nine Months Ended September 30, | | | | | |
|----------------------------|---------------------------------|---------|----------|---------|---------|---------|
| | 2006 | Revenue | 2005 | Revenue | Dollars | Percent |
| | % of | % of | % of | % of | Change | |
| Marketing and selling | \$ 2,372 | 16.1% | \$ 2,183 | 19.8% | \$ 189 | 8.7% |
| Research and development | 3,216 | 21.9 | 2,924 | 26.5 | 292 | 10.0 |
| General and administrative | 1,550 | 10.5 | 1,679 | 15.2 | (129) | (7.7) |
| Total operating expenses | \$ 7,138 | 48.6% | \$ 6,786 | 61.5% | \$ 352 | 5.2% |

Marketing and selling (M&S) expense consists primarily of salaries and benefits, commissions, travel expense and facilities costs related to sales and marketing personnel, as well as marketing program-related costs including trade shows and advertising. The increase in M&S expense for the three months ended September 30, 2006 as compared to the three months ended September 30, 2005 was primarily the result of a \$87 increase in salaries and wages due to an increase in headcount and commissions and \$20 in non-cash stock-based compensation expense related to our adoption of SFAS 123(R) as of January 1, 2006 partially offset by a \$78 decrease in advertising and marketing activities including tradeshow participation. The increase in M&S expense for the nine months ended September 30, 2006 as compared to the nine months ended September 30, 2005 was primarily the result of a \$151 increase in salaries due to an increase in headcount and commissions due to the increase in commissionable sales and a \$56 increase from non-cash stock-based compensation expense partially offset by a \$27 decrease in advertising and marketing activities including tradeshow participation. The decrease in trade show participation is due to the timing of shows during the year and we expect that trade show expense will increase on a year to year comparison. We expect that M&S expense will continue to increase during 2006 as we continue to add sales personnel and increase marketing activities to support a growing revenue and customer base.

Research and development (R&D) expense consists primarily of salary and benefit costs, contracted third-party development costs, and facility costs related to software developers and management. The increase in R&D expense for the three months ended September 30, 2006 as compared to the three months ended September 30, 2005 was primarily the result of increases in headcount and salaries of \$83, \$16 in non-cash stock-based compensation expense related to our adoption of SFAS 123(R) as of January 1, 2006, and a \$64 increase in the use of third party contractors. These increases were partially offset by decreases in facility and equipment related costs of \$35. The increase in R&D expense for the nine months ended September 30, 2006 as compared to the nine months ended September 30, 2005 was primarily the result of increases in headcount and salaries of \$165, \$28 in non-cash stock-based compensation expense, and a \$102 increase resulting from the use of third party contractors. We expect our development efforts to continue at a similar level during the remainder of 2006 and expect our R&D expense to increase in absolute dollars but not as a percentage of revenue.

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General and administrative (G&A) expense consists primarily of salaries, benefits, and other related costs including travel and facility expenses for finance, human resource, legal and executive personnel, legal and accounting professional services, provision for bad debts and director and officer insurance. The increase in G&A for the three months ended September 30, 2006 as compared to the three months ended September 30, 2005 is primarily due to increases in professional fees primarily for audit and accounting services and directors fees totaling \$49, \$43 in non-cash stock-based compensation expense due to our adoption of SFAS 123(R) affective January 1, 2006, and \$33 from an increase in reserves for bad debts. These increases were partially offset by the non-recurrence of legal costs to defend against certain trademark infringement lawsuits of \$85 incurred during the three months ended September 30, 2005. The decrease in G&A for the nine months ended September 30, 2006 as compared to the nine months ended September 30, 2005 reflects the non-recurrence of legal costs to defend against certain trademark infringement lawsuits of \$364 incurred during the nine months ended September 30, 2005. This decrease was partially offset by an increase in professional fees primarily for audit and accounting services, directors fees and corporate insurance costs totaling \$68, an increase in salary costs due to an increase in headcount and salary increases of \$69, and \$103 in non-cash stock-based compensation expense due to our adoption of SFAS 123(R) affective January 1, 2006. We expect salaries, benefits, headcount, and related costs will increase at similar rates during the remainder of 2006.

Other income and (expense), net:

| | Three Months Ended September 30, | | | | | |
|--------------------------------|----------------------------------|--------------|--------------|--------------|--------------|---------------|
| | 2006 | | 2005 | | Change | |
| | \$ | % of Revenue | \$ | % of Revenue | Dollars | Percent |
| Legal fee reimbursement | \$ 93 | 1.8% | \$ 14 | 0.4% | \$ 79 | 564.3% |
| Interest and other income, net | | | | | | |
| Total Other Income | \$ 93 | 1.8% | \$ 14 | 0.4% | \$ 79 | 564.3% |

| | Nine Months Ended September 30, | | | | | |
|--------------------------------|---------------------------------|--------------|--------------|--------------|---------------|----------------|
| | 2006 | | 2005 | | Change | |
| | \$ | % of Revenue | \$ | % of Revenue | Dollars | Percent |
| Legal fee reimbursement | \$ 464 | 3.2% | \$ 464 | 0.4% | \$ 464 | 1445.0% |
| Interest and other income, net | 154 | 1.0 | 40 | 0.4 | 114 | 285.0 |
| Total Other Income | \$ 618 | 4.2% | \$ 40 | 0.4% | \$ 578 | 1445.0% |

Other income includes interest income earned on cash and money market instruments net of interest expense. Interest income has increased due increases in both the amount of cash and cash equivalents invested in money market instruments and the rate of interest being earned on those balances. The legal fee reimbursement resulted from the May 17, 2006 award by the U.S. District Court for the Northern District of Illinois in connection with the TrueDoc lawsuit to Bitstream of approximately \$463,500. Monotype Imaging, Inc. and International Typeface Corporation agreed to pay the full amount of the award and dismiss their appeal if Bitstream agreed not to appeal the Court's award set forth in the Court's May 17, 2006 Order. Bitstream accepted the proposal, received full payment and the case was terminated.

Table of Contents**Provision for income taxes:**

| | Three Months Ended September 30, | | | | | |
|----------------------|----------------------------------|--------------|-------|--------------|---------|----------------|
| | 2006 | % of Revenue | 2005 | % of Revenue | Dollars | Percent Change |
| Income tax provision | \$ (9) | (0.2)% | \$ 32 | 0.8% | \$ (41) | (128.1)% |

| | Nine Months Ended September 30, | | | | | |
|----------------------|---------------------------------|--------------|-------|--------------|---------|----------------|
| | 2006 | % of Revenue | 2005 | % of Revenue | Dollars | Percent Change |
| Income tax provision | \$ 27 | 0.2% | \$ 33 | 0.3% | \$ (6) | (18.2)% |

The tax provision for the three months ended September 30, 2006 included an \$(11) benefit in U.S. Federal income tax due to a refund of alternative minimum tax and \$2 of foreign withholding taxes. The tax provision for the nine months ended September 30, 2006 included \$23 of expense for U.S. Federal alternative minimum tax and \$4 of foreign withholding taxes. The Company did not have a provision for U.S. Federal tax during the same periods ended September 30, 2005 due to taxable losses and did not record a provision for state income taxes during any of these periods due to taxable losses and loss carry forwards. Our tax provision for the three and nine month periods ended September 30, 2005 consisted of foreign withholding taxes of \$32 and \$33, respectively. Foreign taxes vary with OEM license royalties from customers in countries who are party to tax conventions with the United States including Korea and Poland.

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

The Company has funded its operations primarily through the public sale of equity securities, cash flows from operations, cash received from the sale of our MediaBank and InterSep OPI product lines to Inso Providence Corporation in August of 1998, and cash received from the sale of our investment in DiamondSoft to Extensis in July of 2003. As of September 30, 2006, we had net working capital of \$8,594 versus \$4,528 at December 31, 2005, an increase of \$4,066 or 90.0%.

Our operating activities generated \$3,285 in cash during the nine months ended September 30, 2006 primarily due to our \$2,604 net income before adjustment for non-cash expenses and an increase in deferred revenue of \$365. Our operating activities generated cash of \$448 during the nine months ended September 30, 2005 primarily due to our \$246 net income before adjustment for non-cash expenses and an increase in deferred revenue of \$229. Our investing activities used cash of \$175 and \$155 for the nine months ended September 30, 2006 and 2005, respectively, for the purpose of acquiring additional property and equipment and intangible assets. Our financing activities provided cash of \$1,245 and \$101 from the exercise of stock options for the nine months ended September 30, 2006 and 2005, respectively.

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

As of September 30, 2006, we had no material commitments for capital expenditures. From time to time, we evaluate potential acquisitions of products, businesses and technologies that may complement or expand our business. Any such transactions consummated may use a portion of our working capital or require the issuance of equity or debt.

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

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

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This accounting standard will be effective for us beginning January 1, 2007. We are currently assessing the provisions of FIN 48.

In September 2006, the Securities and Exchange Commission (the SEC) Staff issued Staff Accounting Bulletin No. 108 (SAB 108) addressing how the effects of prior-year uncorrected financial statement misstatements should be considered in current-year financial statements. SAB 108 requires registrants to quantify misstatements using both balance-sheet and income-statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relative quantitative and qualitative factors. SAB 108 does not change the SEC staff's previous guidance in Staff Accounting Bulletin No. 99 on evaluating the materiality of misstatements. SAB 108 addresses the mechanics of correcting misstatements that include the effects from prior years. Additionally, SAB 108 requires registrants to apply the new guidance for the first time that a registrant identifies material errors in existence at the beginning of the first fiscal year ending after November 15, 2006 by correcting those errors through a one-time cumulative effect adjustment to beginning-of-year retained earnings. We do not anticipate the adoption of SAB 108 to have a material effect on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), which establishes a comprehensive framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. Specifically, SFAS No. 157 sets forth a definition of fair value, and establishes a hierarchy prioritizing the inputs to valuation techniques, giving the highest priority to quoted prices in active markets for identical assets and liabilities and the lowest priority to unobservable inputs. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The provisions of SFAS No. 157 are generally required to be applied on a prospective basis. We do not expect this standard to have a material effect on our financial position, results of operations or cash flows.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments.

As of September 30, 2006, we did not participate in any derivative financial instruments or other financial and commodity instruments for which fair value disclosure would be required under SFAS No. 107. All of our investments are short-term money market accounts and bank deposits that are carried on our books at fair market value. Accordingly, we have no quantitative information concerning the market risk of participating in such investments.

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Primary Market Risk Exposures

Our primary market risk exposures are in the areas of interest rate risk and foreign currency exchange rate risk. Our investment portfolio of cash equivalent and short-term investments is subject to interest rate fluctuations, but we believe this risk is immaterial due to the short-term nature of these investments. Our exposure to currency exchange rate fluctuations has been and is expected to continue to be modest due to the fact that the operations of our international subsidiary when it is active are almost exclusively conducted in the local currency. Our international subsidiary is currently inactive and the impact of currency exchange rate movements on inter-company transactions was immaterial for the three and nine month periods ended September 30, 2006. International subsidiary operations, if resumed, will be translated into U.S. dollars and consolidated for reporting purposes. Currently, we do not engage in foreign currency hedging activities.

ITEM 4. CONTROLS AND PROCEDURES

Based on the evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of September 30, 2006, each of Anna Chagnon, Chief Executive Officer, and James Dore, Chief Financial Officer, of the Company, have concluded that our disclosure controls and procedures were (1) effective to ensure that information required to be disclosed by us in this quarterly report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (2) designed to ensure that information required to be disclosed was accumulated and communicated to the Company's CEO and CFO to allow timely decisions regarding required disclosure.

There were no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2006 that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

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

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On June 24, 2003, Monotype Imaging, Inc. (formerly Agfa Monotype Corporation) and International Typeface Corporation filed a complaint in the U.S. District Court for the Northern District of Illinois Eastern Division claiming that we, through our TrueDoc software, infringed trademarks and copyrights and violated the Digital Millennium Copyright Act. A judge of the U.S. District Court for the Northern District of Illinois Eastern Division ruled in our favor on all counts. In her opinion issued on July 12, 2005, the Judge found that we were not liable under any claims of contributory infringement, contributory trademark infringement, or infringement under the Digital Millennium Copyright Act. Previously, on April 21, 2005, the court held that we were not liable under claims for direct copyright or trademark infringement or for vicariously infringing Monotype Imaging, Inc.'s and International Typeface Corporation's copyrights. Monotype Imaging, Inc. subsequently filed a Notice of Appeal with the court. On May 17, 2006 the U.S. District Court for the Northern District of Illinois in connection with the TrueDoc lawsuit awarded Bitstream approximately \$463,500 for legal fees, costs and expenses. Monotype Imaging, Inc. and International

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Typeface Corporation agreed to pay the full amount of the award and dismiss their appeal if Bitstream agreed not to appeal the Court's award set forth in the Court's May 17, 2006 Order. Bitstream accepted the proposal, received full payment and the case has been terminated.

From time to time, in addition to the infringement case identified above, we are subject to legal proceedings and claims in the ordinary course of business, including claims of infringement of third-party patents and other intellectual property rights, commercial, employment and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. This provision is reviewed at least quarterly. As of September 30, 2006 no liability was recorded. Litigation is inherently unpredictable and it is possible that our financial position, cash flows, or results of operations could be materially affected in any particular period by the resolution of any such contingencies or the costs involved in seeking the resolution of any such contingencies.

ITEM 1A. RISK FACTORS

There have not been any material changes in the risk factors previously disclosed in our Form 10-K for the period ended December 31, 2005 filed with the SEC on March 30, 2006.

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

(a) Instruments defining the rights of the holders of any class of our registered securities have not been materially modified during the three months ended September 30, 2006.

(b) Rights evidenced by any class of our registered securities have not been materially limited or qualified by the issuance or modification of any other class of securities during the three months ended September 30, 2006.

(c) There were no unregistered securities sold by us during the three months ended September 30, 2006.

(d) There were no repurchases by us of our equity securities during the three months ended September 30, 2006.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

None

ITEM 5. OTHER INFORMATION

- (a) Consistent with Section 10A(i)(2) of the Securities Exchange Act of 1934 as added by Section 202 of the Sarbanes-Oxley Act of 2002, the Company is responsible for listing the non-audit services approved during any reporting period by its Audit Committee to be performed by PricewaterhouseCoopers LLP, the Company's external auditor. All non-audit services are pre-approved by the Audit Committee or the Audit Committee's Chairman pursuant to delegated authority by the Audit Committee. There were no such matters brought before the Audit Committee and the Audit Committee did not pre-approve any amount for services during the three months ended September 30, 2006.

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- (b) There have been no changes to the procedures by which security holders may recommend nominees to the Company's Board of Directors.

ITEM 6. EXHIBITS

- (a) Exhibits

CERTIFICATIONS

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

PART II - SIGNATURES

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

BITSTREAM INC.

(Registrant)

| SIGNATURE | TITLE | DATE |
|--|--|-------------------|
| /s/ Anna M. Chagnon Anna M. Chagnon | President and Chief Executive Officer (Principal Executive Officer) | November 14, 2006 |
| /s/ James P. Dore James P. Dore | Vice President and Chief Financial Officer (Principal Accounting Officer) | November 14, 2006 |