

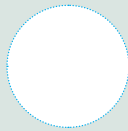


solutions
for music education

INSPIRING MUSICIANS,
EMPOWERING EDUCATORS, AND
MEETING ASSESSMENT STANDARDS

2006 ANNUAL REPORT

make**music**®



TAKE THE **TOUR**



see and hear how SmartMusic 10.0 supports current education standards and establishes the value of music programs across the nation.

SMARTMUSIC transforming *music education*



motivate and inspire

SmartMusic® gives students an exceptional music experience and helps them discover a lifelong love of music.

practice and perfect

The fun, interactive environment provides instant, personalized feedback that motivates students to practice longer and more often.

guide and grade

Teachers have the ability to give graded music assignments for home practice, freeing them to devote more time to teaching musical expression.

perform and enjoy

Students come to class better prepared and teachers and parents can hear the results.



a vital tool

As teachers face increasing pressure to provide documented proof of student achievement, SmartMusic Impact™ will become an essential asset. This web-based service allows teachers to easily manage assignments and grades for hundreds of students while meeting assessment requirements.

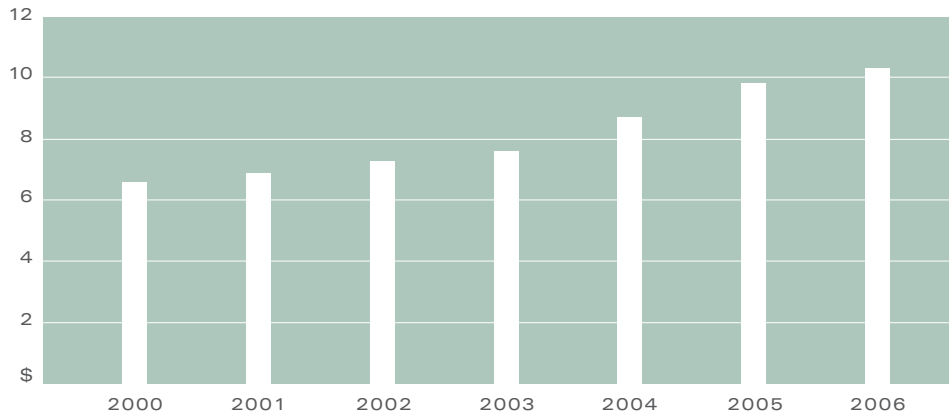
with SmartMusic Impact, teachers can:

- Select and send assignments to every student in less than a minute
- Track the time students spend practicing
- Instantly view the progress of every student in all classes
- Automatically calculate the grades for each student

2006 HIGHLIGHTS

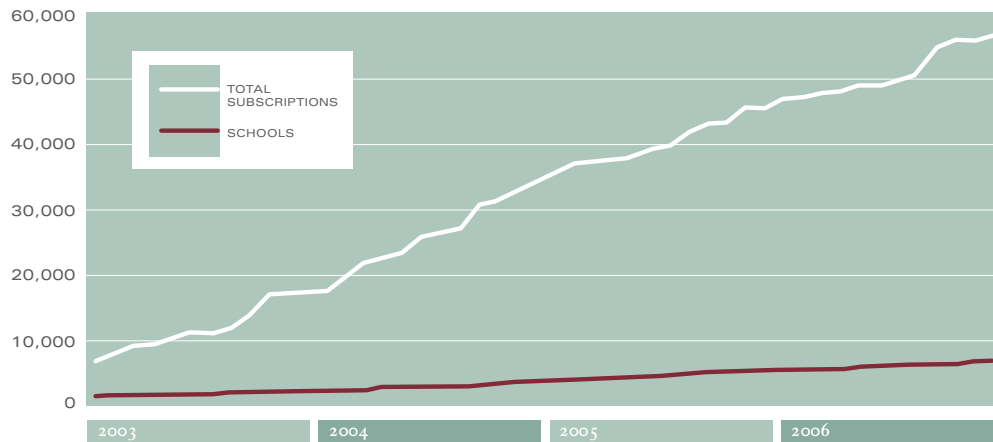
FINALE

ANNUAL GROWTH – FINALE NOTATION FAMILY IN MILLIONS



SMARTMUSIC

SMARTMUSIC SUBSCRIBERS 2003-2006



new ways to measure Smart Music growth

The adoption of SmartMusic Impact by music educators will contribute to a dynamic change in our business model. The company will use the following measurements to track SmartMusic's growth in the future:

total number of SmartMusic teacher subscriptions

- The number of teachers who are using SmartMusic

number of SmartMusic Impact teachers

- The number of SmartMusic teachers using Impact's web service and requiring SmartMusic assignments

average number of students per SmartMusic Impact teacher

- The number that drives significant growth and shareholder value

LETTER TO THE SHAREHOLDERS

2006 proved to be another year of growth and achievements for your company. Finale and SmartMusic posted record sales to contribute to a profitable year. We continue to garner support from educators, publishers, and industry partners. Cash reserves are sufficient to execute our strategies and are likely to increase as investor warrants are exercised. In addition, your management team has been significantly strengthened with Karen VanDerBosch joining us as Chief Financial Officer and Mary Schneider joining us as Chief Marketing Officer.

That said, 2006 was a disappointing year. We did not meet the scheduled release date for SmartMusic 10.0 along with its companion web service, SmartMusic Impact. The questions you deserve answers to are 1) Why the delay? and 2) Why does it matter so much?

The answer to why the delay is two-fold. First, the complexities of using audio recordings (as opposed to synthesis) as accompaniments required much more experimentation than predicted. Second, refining the coordination between the SmartMusic application and the Impact web service proved to require unexpected development and testing time. Achieving the desired state of intuitive use has required repeated beta testing, redesign, and further development. The result: We missed our 2006 release date, but we are committed to insuring a positive first impression to SmartMusic 10.0 and Impact.

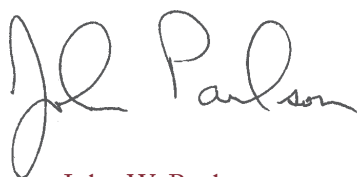
The answer to why does the delay matter so much is because the combination of SmartMusic 10.0 and Impact represents the most important advance in SmartMusic's history. In the past, SmartMusic has received awards and praise for fostering student achievement related to solo literature, solo contests, and development of expression and musicianship. Solo contest preparation, however, is not directly applicable to 95% of what teachers and students do every day in their band, orchestra, and choir rehearsals: preparing music for public performance.

SmartMusic 10.0 and Impact will do exactly that. For the first time, home computers are fast enough for SmartMusic to use audio recordings and thus help teachers prepare large ensemble music for public performances. Using SmartMusic in combination with Impact to post SmartMusic assignments, teachers will be guiding, motivating, and tracking home practice in ways previously unimaginable. In the process, they also will be documenting the personal growth of each student... a necessity in this age of *No Child Left Behind*.

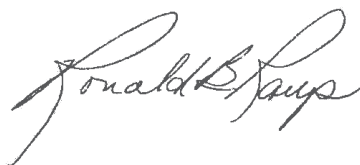
We believe it is these SmartMusic assignments that will drive home subscriptions. At \$25 per year, most students will prefer to practice, perfect, and submit assignments at home versus waiting in line for a school computer to become available. This is why SmartMusic is priced affordably: It isn't just for the richest or best students, but for every student.

Furthermore, teacher reaction to demonstrations of SmartMusic and Impact is very encouraging. It suggests that we will deliver the solution teachers want and need to dramatically improve their music programs while being accountable to parents, administrators, and school boards. We believe SmartMusic will show some of its growth potential beginning late 2007 and throughout 2008. We thank you for your support and patience with this worthwhile venture.

Respectfully,



John W. Paulson,
CHIEF EXECUTIVE OFFICER



Ronald B. Raup,
PRESIDENT AND CHIEF OPERATING OFFICER

FINALE

leveraging notation technology to expand
the family of products



finale[®]

We will shape the future of notation technology by expanding our premier brand family and continuing to offer software that inspires musicians and empowers teachers.



- **FINALE** The world's best-selling notation software for composing, arranging, listening to, and printing music
- **ALLEGRO** Users can create publisher-quality scores for teaching, playing, editing, composing, arranging, and sharing
- **PRINTMUSIC** Perfect for students, teachers, church musicians, and songwriters
- **SONGWRITER** The fast, easy way for songwriters to create and print professional-quality sheet music

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-KSB

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

Commission File No.: 0-26192

MakeMusic, Inc.

(Name of Small Business Issuer as specified in its charter)

Minnesota
(State or other jurisdiction of
incorporation or organization)

41-1716250
(IRS Employer
Identification Number)

7615 Golden Triangle Drive, Suite M, Eden Prairie, MN 55344
(Address of principal executive offices)(Zip Code)

Issuer's telephone number, including area code: **(952) 937-9611**

Securities registered pursuant to Section 12(b) of the Exchange Act: Common Stock

Securities registered pursuant to Section 12(g) of the Exchange Act: None

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. []

Check whether the Issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained herein, and no disclosure will be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [X]

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

Yes No

Issuer's revenues for its most recent fiscal year: \$12,978,000

The aggregate market value of the Common Stock held by non-affiliates of the Registrant as of February 28, 2007 was approximately \$23,987,891 based upon the closing price of the Registrant's Common Stock on such date.

There were 4,072,647 shares of Common Stock outstanding as of February 28, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement for its 2007 Annual Meeting are incorporated by reference into Part III.

Transitional Small Business Disclosure Format (check one). Yes No

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PART I

ITEM 1. DESCRIPTION OF BUSINESS

General

MakeMusic, Inc., a Minnesota corporation, is a world leader in music education technology whose mission is to enhance and transform the experience of making, teaching, and learning music. The Company's predecessor corporations, which merged to form the current entity in 1992, were incorporated in Minnesota in 1990. Among the Company's leading products are SmartMusic® music learning software, Finale®, music notation software, and SmartMusic Impact™, the web-based solution that will allow music educators to easily guide, motivate, grade, and document individual student progress.

SmartMusic is a complete teaching and learning tool for band, jazz band, orchestra, and choir. SmartMusic enhances and transforms the process of practicing music by providing students with professional accompaniment and a variety of built-in practice tools. Practicing with SmartMusic is more fun than practicing alone, and as a result students practice longer and more effectively. This leads to increased confidence, higher retention, and stronger music programs. Offered through subscription, SmartMusic gives musicians access to a library of more than 30,000 professionally performed and recorded accompaniments and more than 50,000 exercises.

The introduction of SmartMusic 10.0 in the first half of 2007 will provide music educators with exciting new tools to help develop strong music programs and comply with today's accountability requirements. SmartMusic now provides access to an ever-increasing library of full ensemble literature. Each title includes individual assignments for every part, all of which are authored by respected educators. These pre-authored assignments offer music teachers a great savings in time as they prepare for their next public performance.

When educators distribute SmartMusic assignments to their students, the students respond by practicing the assignments in SmartMusic and receiving real-time feedback from SmartMusic's assessment and recording features. Students immediately see their assessment scores and hear their recordings and are then motivated to improve prior to submitting the assignment to their teacher. This combined visual and aural feedback helps students improve on their own and understand how they are progressing.

SmartMusic Impact will fully automate the administrative process of sending SmartMusic assignments between educators and students. It manages audio recordings and practice reports, tracks assignments, and provides educators with on-line libraries that make it easy to share assignments with colleagues. Students complete assignments on their home computer (provided that they have a SmartMusic subscription) or on a school computer equipped with SmartMusic. Submitted assignments are automatically graded and posted in the teachers' SmartMusic Gradebook™. SmartMusic Impact provides educators the means to guide, motivate, grade, and document the progress of every student.

For more than fifteen years, Finale has been the best-selling music notation software. It has transformed the process by which composers, arrangers, musicians, teachers, students, and publishers create, edit, audition, print, and publish musical scores. In the world of music software, Finale is the equivalent of Adobe® PageMaker® or InDesign® – it is what musicians use for page layout of sheet music. An additional feature of Finale is its ability to make SmartMusic files so that an educator/composer can create customized practice assignments for their students. MakeMusic has continued to expand its leadership through developing and marketing a family of notation products with reduced features and pricing which appeals to new market sectors and distribution channels.

Strategy

MakeMusic works with teachers, suppliers, associations, and publishers in a proactive collaboration to meet the needs of active music-makers and to develop products for them. The long-term

and global leadership that our Finale software has established with music educators and publishers provides MakeMusic with credibility and development opportunities for SmartMusic and other new products.

The worldwide market for products and services sold to educators, students, hobbyists, and professional musicians is estimated by the Company to be approximately \$15.5 billion, with music software as one of its fastest-growing segments. This estimate is based on data contained in the Music Products Association 2006 Music USA NAMM® Global Report. As music educators search for time-saving solutions in motivating students and complying with accountability requirements, MakeMusic is building on its leadership position to become a key driver in the future of music education. According to polls sponsored by the American Music Conference, the public understands the importance and benefits of arts in education. Parents expect access to student assignments and the grading process. We believe that MakeMusic is uniquely posed to offer continuous innovation to music educators, music students and parents. Additionally, as accountability for individual student progress becomes more and more important, SmartMusic may be the best, if not the only, solution in the market today for educators to easily and objectively document individual student progress.

MakeMusic’s business strategy is characterized by the following principles:

Focus on meeting the needs of a highly influential niche market. By focusing on providing superior, long-lasting solutions for music educators, MakeMusic gains exceptional access to the larger market of student and hobbyist musicians at the lowest possible cost.

Deliver high-quality patented technologies and licensed content. The complexity of the notation and Intelligent Accompaniment® technologies at the core of MakeMusic’s products represent a significant barrier to entry to competition. Furthermore, we hold licenses to a major library of music, adding significantly to this barrier.

Capitalize on fundamental shifts in the marketplace. MakeMusic’s products support two shifts that are leading to long-term growth opportunities: its products support the adoption of the “digital lifestyle” in which music is a market driver; and its products provide the building blocks that meet the demand for quantification and assessment in education.

Leverage an extensive customer database for targeted direct marketing. With an active database of nearly a half-million musicians, MakeMusic is able to target, personalize and develop each customer’s buying potential in an optimal fashion. Supporting this initiative, MakeMusic’s management has significant operational experience in customer relationship management businesses.

Grow the SmartMusic business by leveraging support of music educators. MakeMusic introduced an annual subscription for teachers late in 2001 and a monthly subscription for home users in the spring of 2002. In October 2002, we launched the school-sponsored student subscription program, allowing schools to sponsor their students’ home use of SmartMusic at substantial discounts. Teachers using SmartMusic report students have more fun, practice longer, and improve technical skills faster. With the introduction of SmartMusic Impact in 2007 and an ever-expanding library of repertoire, we will provide teachers more efficient tools to assist every student practicing for the next performance while also complying with assessment requirements. Teachers using SmartMusic are our most effective advocates, and we continue to expand marketing activities based on viral marketing tactics. Today over 40% of teachers subscribing to SmartMusic report that they first heard about SmartMusic from a colleague.

Build visibility and credibility by partnering with industry suppliers and associations. MakeMusic has initiated relationships with several leading instrument and education member associations. These partnerships enable each association to promote SmartMusic discounts as an important member benefit. MakeMusic benefits from the visibility and credibility through the implied endorsement of our software. Examples of these associations include the Suzuki Association of the Americas, the International Association of Jazz Education, the Associated Board of the Royal Schools of Music, the International Trumpet Guild, the International Trombone Association, and the North American Saxophone Alliance. In addition, music publishers are placing more importance on having their titles supported with SmartMusic.

Publishers are demonstrating this importance through SmartMusic licensing, authoring SmartMusic assignments, and by featuring the SmartMusic logo with new education releases as a means of providing market differentiation.

Maintain and strengthen Finale market leadership and revenues. Finale music notation software is accepted worldwide as the industry standard. We will seek to maintain Finale revenues by continuing to introduce innovative upgrades and expanding the line of Finale branded products. MakeMusic intends to grow revenues by expanding marketing throughout the world and expanding our distribution into underserved markets.

Partner with leading industry players. MakeMusic is continuing to pursue and expand strategic alliances with entities that have the marketing power and capital resources to fully exploit our products' potential around the world. We will also pursue alliances that enhance our technology base into complementary music and educational markets. Already, we have forged key strategic relationships with: McGraw-Hill, the largest music textbook publisher; Hal Leonard Corporation, the largest sheet music publishing company; Conn-Selmer, the largest manufacturer of band and orchestral instruments and accessories in the United States; and Berklee College of Music, the world's premier learning lab for the music of today.

Grow the business step by step. MakeMusic currently has sufficient capital necessary to continue the product development and marketing efforts necessary to grow our business. We are planning to continue business development with careful attention to cash management while continuing to grow revenues with a view toward profitability.

Products

SmartMusic®. SmartMusic is a complete, interactive, computer-based music system that transforms and modernizes the way a musician practices by providing human-like accompaniment in a wide range of musical styles performed by orchestras, concert bands, jazz trios, and other musical ensembles. Its key innovation, Intelligent Accompaniment®, enables SmartMusic to listen to a musician as they sing or play and follow their spontaneous tempo changes. In addition, SmartMusic allows the user to start playing at any point in a musical piece, repeat difficult-to-play segments, change instrumentation, adjust the degree to which the accompaniment follows the musician, control tempo, transpose the music into any key, play with or without repeats or designate sections of the music to cut. The software also includes self-assessment features and allows the user to record their performance, e-mail to friends and relatives, or submit the performance to their teacher. The prototype technology upon which the SmartMusic system is based was patented by Carnegie Mellon University and licensed to us. The patent expired in 2005. We then significantly enhanced the prototype technology with our own proprietary technology and additional patented features, producing a marketable product. SmartMusic is a unique product that has won numerous awards as well as the support of world-class musicians such as Wynton Marsalis, James Galway, Dawn Upshaw and others.

Schools, students and other musicians have access, via subscription, to over 30,000 licensed accompaniments including elementary band methods and classical, jazz, pop, rock, movie, theater, and holiday titles. Starting in 2007 the SmartMusic subscription will also provide access to an increasing library of full concert band, jazz band, and orchestra ensemble repertoire. With SmartMusic Impact, teachers will be able to select pre-authored assignments for every part and guide students as they prepare for their next performance. MakeMusic has entered into license agreements with top music publishers to produce musical arrangements for use with SmartMusic. We have also obtained exclusive rights from major publishers of solo classical works for voice, woodwinds, brass, percussion, strings, and keyboard. These licenses are for the purpose of musical accompaniment, which responds in real-time to the musician. We have developed our accompaniment selections based upon a review of the most frequently performed titles in American academic solo contests as well as popular titles of sheet music sold in the United States. The Company is expanding the library of accompaniments with the primary and immediate focus on repertoire that is most often performed by middle school and high school students participating in concert band, jazz band, orchestra, and choir. In the future, we plan to continue expansion of our library of accompaniments to cover

a broad spectrum of musical genres, instruments and skill levels as well as providing publishers of select institutions to develop content ready for use with SmartMusic. Further, users of our Finale notation software can create their own SmartMusic accompaniments, which can then be played by the SmartMusic software.

In addition, SmartMusic subscribers have access to a selection of accompaniments to more than 50,000 skill-development exercises based on scales, intervals, arpeggios, and twisters. The product also features warm-up exercises for vocalists, the ability to insert tempo changes with variations in speed and the ability to insert breath marks and cues to wait for a particular tone. These “variables” can be saved with the music, creating a personally customized version of the accompaniment. SmartMusic provides accompaniments for band and string instruments as well as for vocalists.

The individual subscription program, currently priced at \$9.95 per month or \$100 per year, was launched in 2002. In response to teachers’ requests to have an offer which would encourage all their students to use SmartMusic at home, we developed and launched a school-sponsored student subscription program which currently allows participating students to buy a subscription for \$25 per year. The students may purchase their subscription from the school or may purchase directly from the SmartMusic website (www.smartmusic.com) using a code generated by their teacher. In 2005, we introduced the ability to sponsor members and to generate codes for organizations of musicians. We believe that the SmartMusic subscription-based revenue model, with its recurring revenue stream, offers a significant opportunity to increase profitability. MakeMusic also sells a packaged SmartMusic Starter Kit through dealers, for a suggested retail price of \$129.95 that includes a one-year subscription plus a vocal and instrumental microphone. In early 2006 we authorized a select group of dealers that specialize in selling to music educators, to offer SmartMusic subscriptions to schools and sponsored students.

SmartMusic Impact. Music teachers typically focus on rehearsing students for the next performance. With the expanding library of SmartMusic accompaniments teachers are able to guide and motivate students by requiring completion of any of the pre-authored SmartMusic assignments. SmartMusic Impact will be a web service included with SmartMusic educator subscriptions. This service allows teachers to select and send assignments in less than a minute. Students automatically receive assignments when they log-in to SmartMusic and submit assignments to their teachers with one click. SmartMusic assessment assignments are automatically graded and are entered into the teacher’s SmartMusic Impact Gradebook while audio recordings, which require educator feedback, are indicated as “waiting for evaluation.” SmartMusic Impact provides a way of guiding student development and moreover provides teachers with a means to easily and objectively measure student progress in a way that complies with current assessment standards.

Finale notation family. We are a market leader in music notation software with our Finale family of products for use with Macintosh® and Windows® PC operating systems. Music notation software enables a musician to enter musical data into a computer using either the computer keyboard, a MIDI- (Musical Instrument Digital Interface) equipped electronic music keyboard or other MIDI-equipped instruments and contemporaneously display the data on a computer screen as a musical score. The dramatic improvements in speed and flexibility provided by software programs like Finale have made such software the dominant method for composers, arrangers, publishers and music teachers to create printed music.

The Finale product is a powerful and comprehensive notation software product which is sold worldwide. Finale music notation software has a suggested retail price of \$600. Finale software is differentiated from other music notation software by its breadth and depth of features, including patented capabilities such as its “hyperscribe” feature. HyperScribe® allows users to freely play music with varying tempos via a MIDI keyboard while the software interpolates the rhythms and accurately notates the music in real time.

We also produce an Academic/Theological Edition of the Finale product that is sold exclusively to schools, teachers, college students and religious organizations at a suggested retail price of \$350. This edition has been a key source of revenue and registered user base growth. In addition, it reaches a market that is continuously being replenished with new student users.

The Finale product is currently translated into German, French, Italian, and Japanese. We believe the international market is a key growth opportunity as computer penetration increases worldwide.

The Finale Allegro® product, a value-priced version of the powerful Finale music notation software product, was introduced in 1993. The Allegro music notation software product currently retails for \$199 and contains a subset of the notation tools contained in the Finale product. With extensive MIDI capabilities, Allegro is targeted to an audience that may not read music but needs to create “lead sheets” for other musicians.

Finale PrintMusic® and Finale SongWriter are entry-level, yet powerful music notation software products, retailing for \$99.95 and \$49.95 respectively. Each contains a subset of the notation tools contained in the Finale and Finale Allegro products. These products allow us to offer entry-level products to the retail customer, thereby expanding the base of registered users and increasing the potential for sales of notation software upgrades. These products are targeted to a broad audience in the education and general consumer marketplace.

Finale NotePad® is a downloadable “freeware” introduction to the Finale notation family. As of December 31, 2006, there were approximately 1.5 million unique users of NotePad with approximately 2.9 million total downloads of NotePad.

Synergy between Product Lines

From a technology perspective, there are considerable synergies between the SmartMusic business and the Finale notation business because the products benefit from shared technologies. The Finale notation technology, for example, is used within SmartMusic to display, among other things, sheet music, exercises, and beginning band method songs. It is this technology that puts red and green notes on the screen to show SmartMusic students what they did wrong and how to do it right. Similarly, the SmartMusic pitch recognition technology is used within Finale in its MicNotator® feature, which allows Finale users to enter notes by simply playing an acoustic instrument into a microphone. Indeed, the synergistic integration between SmartMusic and Finale notation products represents a significant differentiator for our notation products and provides a significant barrier to entry into the marketplace. Likewise, the ability to effortlessly create SmartMusic repertoire using the Finale product is a major benefit for SmartMusic customers.

More important than the technology synergies, however, are the market and customer synergies. We estimate that Finale is well-established in over 30,000 schools, all of which are targets for SmartMusic. The school teachers/decision-makers know and respect Finale and are willing to consider new products from MakeMusic. Similarly, the Finale channels of distribution are anxious to build upon their continuing Finale sales with new products from MakeMusic.

Technology Infrastructure

The MakeMusic® data center is operated internally, offering extensive uptime and connectivity to the Internet backbone via fiber-optic connections. For maximum reliability, all our servers utilize redundant arrays of independent discs for information backup as well as redundant power. We are currently utilizing state-of-the-art hardware and software platforms. Web services are run on Microsoft IIS® and Apache® servers. A combination of Microsoft SQL® and Oracle® are used for database applications. Our network is monitored twenty-four hours a day, seven days a week, and is scalable and upgradeable for future growth.

www.smartmusic.com. The SmartMusic website promotes our SmartMusic subscriptions and SmartMusic accessories.

www.finalemusic.com. The Finale website promotes notation products and e-commerce with mail-order fulfillment and also downloads of Finale NotePad.

www.makemusic.com. The MakeMusic website includes information on the Company and its products. It also provides links to www.smartmusic.com and www.finalemusic.com for people wanting to make purchases of the Company's products.

Marketing, Sales and Distribution

SmartMusic. MakeMusic believes its future revenue growth will be primarily driven by its revolutionary product SmartMusic, which is computer software that incorporates complete music practice system. SmartMusic features award-winning Intelligent Accompaniment technology and the world's largest library of interactive music accompaniments.

The market for SmartMusic is large, with student use being the biggest potential market. There are over 100,000 school buildings in the U.S. that have approximately 15 million students enrolled in band, orchestra, and choir programs. The school-sponsored student subscription offering encourages teachers to be advocates to students and parents for SmartMusic at home. We believe the key to expanding the number of subscriptions for students is in producing a compelling reason for educators to make SmartMusic an integral part of how they deliver lesson plans and to make assignments given through SmartMusic a necessary part of their curriculum. We believe that SmartMusic Impact will break down many of the barriers that have previously limited our reach.

We expect that our expanding subscription sales model, if accomplished, will increase gross profit by creating a recurring stream of revenues and cash flow. The success of our sales model is dependent on the rate at which schools adopt the SmartMusic system and on our ability to establish long-term customer relationships with SmartMusic subscribers. We plan to focus on adoption and customer satisfaction to leverage the school-sponsored student subscription model.

MakeMusic currently utilizes a variety of marketing channels to achieve the best mix for profitable growth. In the United States, Canada and United Kingdom, SmartMusic is being marketed by e-marketing, music association membership, trade shows, exposure at music educator conferences, and advertising in targeted print media. We also place considerable emphasis in viral marketing activities that include utilizing experienced music educators in our educator support system ("ESS"), to help us reach their fellow music educators.

In addition, we have developed SmartMusic Intelligent Accompaniment software for Hal Leonard's Essential Elements®, the world's best-selling method books for beginning band and strings students. This is part of a strategic partnership with Hal Leonard Corporation, the world's largest sheet music publisher. This relationship is very important because students usually start to play in a school band in the fifth grade. In the United States alone, there are approximately 2.5 million students starting band every year. If many of these students have a successful experience starting out with SmartMusic, they will likely continue with SmartMusic and become users of other MakeMusic products, including Finale software and new products introduced in the future. As a result of a special marketing and licensing agreement, Hal Leonard offers SmartMusic in its Essential Elements Book One for both band and orchestra students, reaching approximately 1 million students per year. Students receive a free trial offer giving them access to accompaniments to the first half of the book; and they may acquire access to the second half of the book at a discounted price as well as become regular subscribers thereafter.

Though the primary distribution for SmartMusic subscriptions is via the www.smartmusic.com website (linked with www.makemusic.com and www.finalemusic.com), we also have a network of education dealers and distributors supporting the SmartMusic Starter Kit designed for sale at retail. Distributors service the music instrument retailers, college bookstore and educational software markets. We are also working with key dealers to implement a beginning band instrument rental opportunity that includes SmartMusic software in the rental package.

Additionally, we market SmartMusic by deploying the program at key partner sites that our current and potential customers may frequent. SmartMusic creates the opportunity to strengthen their music-makers' community while sharing in the revenues from recurring SmartMusic subscription fees.

Offering SmartMusic is extremely easy for a partner site since we project SmartMusic onto their site from our own servers and handle all transactions including back office functions.

The international marketplace in Europe, Latin/South America and Asia is large but, due to vast differences in the way music is taught in those countries, its potential for SmartMusic is currently unknown. Although we have authorized distributors in the United Kingdom and Australia, our primary focus remains on the K-12 market in the United States.

Finale notation family. In the United States and Canada, the Finale family of notation products is sold by a group of channel-specific distributors in the musical instrument and educational channels. Finale is also marketed to educational institutions and specialty retailers on a direct basis. Repeat business is driven by direct marketing to registered users for product upgrades and trade-ups. In early 2006 we signed a domestic distribution agreement with Hal Leonard Corporation, the largest music publisher in the world and, arguably, the largest distributor of music products in North America. We believe this will give us a significant advantage in the highly competitive market for notation software by increasing our visibility to customers.

Internationally, Finale notation products are represented by key distributors in many overseas territories, primarily in Europe and Japan. Finale is translated into German, French, Japanese, and Italian. We believe the international markets present an additional opportunity for future growth.

Music makers can also utilize Finale software to create accompaniments for use with SmartMusic. A Finale file is simply saved as a SmartMusic accompaniment and becomes part of the Intelligent Accompaniment system. This interplay provides MakeMusic with cross-marketing opportunities between Finale and SmartMusic users and products as well as providing a unique differentiator in the marketplace.

We believe we can significantly build on our Finale notation software business by continuously expanding the installed base of users, regularly providing them with upgrades, broadening distribution, producing additional international versions of the products, and establishing the products as a means for electronic transmission of music. Finale upgrades were introduced on both the Windows platform and Macintosh platform in each of the last several years. All Finale products operate on both Windows and Macintosh platforms.

Product Development

At December 31, 2006, 41 employees were involved in product development at MakeMusic. This staff engages in research and development of new products, enhancements to existing products, business systems support, repertoire development and quality assurance testing.

MakeMusic's non-capitalized expenditures for product development were \$3,474,000 and \$3,279,000 in 2006 and 2005, representing 26.8% and 27.7% of revenues, respectively.

We intend to continue to expand our current product offerings by developing products for new applications and markets.

Website. Website development expense consists of expenses required for design and development of the MakeMusic, SmartMusic and Finale websites and underlying technology infrastructure. This primarily includes personnel costs and payments to third-party service vendors. All of our websites are maintained and updated on a regular basis.

In addition, we continue to refine the SmartMusic Internet subscription model and to further develop its distribution capabilities on other Internet websites.

Content and product. Content and product development consists primarily of internal payroll and payments to third parties for the development and ongoing maintenance of notation products and the SmartMusic subscription software.

We continue to license and create additional SmartMusic accompaniments to be included with our subscriptions. The Company has developed processes for creating individual part assignments for every ensemble title. We have also recently developed CD-quality accompaniments that sync with on-screen notation providing an even richer student experience. Additionally, we have automated some of the processes and have developed a technical specification that is used to standardize both quality and process.

We have maintained our competitive position in the music notation marketplace, in part, by focusing our improvement efforts over the past several years on developing upgrades of the Finale product on a regular basis for the Macintosh and Windows platforms. We plan to make annual releases of such upgrades and to continue developing music education products with our proprietary music technologies.

Competition

We believe we are well positioned in music technology markets and benefit from strong barriers to entry for new competitors in our business niches due to our 1) proprietary music notation, Intelligent Accompaniment, and music education software; 2) extensive library of licensed content; 3) credibility in the music education marketplace; and 4) relationships with major industry partners. One competitor is offering a product that is similar to SmartMusic in that it provides accompaniments, on-screen music notation, and assessment. This product, "In the Chair," presently offers a limited amount of repertoire and does not offer any assignment measurement or grading solutions. We know of no other musical accompaniment product for band instruments, string instruments and vocalists that responds to the musician. Several years ago Cakewalk released In Concert™, an interactive accompaniment product limited to MIDI keyboards, but today we are unable to find any mention of In Concert on the current Cakewalk web-site.

We expect that SmartMusic products will also compete with conventional music accompaniment products by Music Minus One by MMO Music Group, Inc. and MTS 120 by Roland Corporation. These products offer students the ability to play along with prerecorded songs. They differ from the SmartMusic product in that they do not automatically adjust in real time to the musician's changes in tempo, they do not provide graphical and numerical assessment, and do not include the ability to receive and submit assignments. We believe SmartMusic is unique because it listens to the musician and adjusts accordingly. We also believe that the synergies between Finale and SmartMusic technologies create feature sets that are difficult for a competitor to replicate.

The notation market is highly competitive and continues to have competitors such as Steinberg Media Technologies GmbH, Sibelius Software, NOTION Music, Inc., and Voyeur Turtle Beach, Inc.

Competitive factors in marketing the SmartMusic and Finale products include product features, quality, brand recognition, ease of use, merchandising, access to distribution channels, retail shelf space, and price. We believe we compete effectively in these areas. In addition, a competitive advantage is that both product lines benefit from shared technologies. For example, the SmartMusic pitch recognition technology is used within Finale in its MicNotator feature, allowing Finale users to enter notes by simply playing an acoustic instrument into a microphone.

Patents

We licensed, from Carnegie Mellon University ("CMU") on a worldwide basis for the life of the patent which expired in 2005, the use of the U.S. patent that covers the automated accompaniment that listens to and follows tempo changes from a live performance. We have further developed this technology and patented additional features. We have obtained five additional patents that protect improvements to the user control of the software and that contain certain aspects of the repertoire file which expand the following capabilities of the software: enhancements to the algorithms, accompaniment controls, and

repertoire data files and miscellaneous interface features of the product. As a result of the additional patented features we have developed, strong synergy with our Finale notation product and continuing development of an extensive library of licensed repertoire, we do not believe that SmartMusic is materially affected by the expiration in 2005 of the CMU patent.

Our Finale product is covered by three separate patents, which protect the data structure, the ability to enter music into the product by tapping tempo with a pedal device or computer keyboard, and the method of automatically assigning guitar fingerboards to a notated chord. These patents are licensed from Wenger Corporation on a royalty-free, exclusive, worldwide basis for the life of the patents.

Trademarks

We own the registered trademarks in the United States for Allegro®, Coda®, Finale Allegro®, Finale NotePad®, Finale Performance Assessment®, Finale PrintMusic®, Finale SongWriter®, Finale®, FinaleScript®, HumanPlayback®, HyperScribe®, Intelligent Accompaniment®, Intonation Trainer®, M!®, MakeMusic®, MicNotator®, SmartMusic®, and The Art of Music Notation®. In addition, the names Coda®, Finale SongWriter®, Finale®, Intelligent Accompaniment®, MakeMusic®, SmartMusic®, and The Art of Music Notation® have been protected in some foreign countries and we have applied for protection in foreign countries for Finale NotePad®, Finale PrintMusic®, Finale Viewer™, and SmartMusic Impact™. We have applied for trademark registration in the United States for Finale Viewer™, FPA™, SmartFind and Paint™, SmartMusic GradeBook™, SmartMusic Impact™, Studio View™, and TempoTap™. In addition to our own registered trademarks listed above, this report also contains references to trademarks owned by third parties.

Manufacturing

Printing of user manuals, packaging, and the manufacture of related materials are performed to our specifications by outside subcontractors. We currently use one subcontractor to perform standard copying and assembling services, including copying software DVD and CD-ROM disks, and assembling the product manuals, disks and other product literature into packages. If this subcontractor is unable to perform, there are alternative vendors that we could use for this service.

Employees

As of December 31, 2006, MakeMusic employed 79 full-time employees. We believe our relations with employees are good. None of our employees are covered by a collective bargaining agreement. In addition, we rely on select independent contractors to help write software and to develop our repertoire or products. We have little difficulty contracting with these individuals and believe that our relationships with them are good. Should we have difficulty securing the services of such persons in the future, it could adversely affect operations.

Available Information

All reports filed electronically by MakeMusic with the Securities and Exchange Commission (“SEC”), including its annual reports on Form 10-KSB, quarterly reports on Form 10-QSB, current reports on Form 8-K, proxy and information statements, other information and amendments to those reports filed (if applicable), are accessible at no cost by contacting the Investor Relations department at MakeMusic. These filings are also accessible on the SEC’s website at www.sec.gov. The public may read and copy any materials filed by the Company with the SEC at the SEC’s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may also obtain information for the Public Reference Room by calling the SEC at 1-800-SEC-0330.

Cautionary Statements

The Private Securities Litigation Reform Act of 1995 (the “Reform Act”) provides a safe harbor for forward-looking statements made by us or on our behalf. We have made, and may continue to make, various written or verbal forward-looking statements with respect to business and financial matters, including statements contained in this document, other filings with the SEC and reports to shareholders. Forward-looking statements provide current expectations or forecasts of future events and can be identified by the use of terminology such as “believe,” “estimate,” “expect,” “intend,” “may,” “could,” “will” and similar words or expressions.

Our forward-looking statements generally relate to our growth strategy (particularly related to SmartMusic), financial results, product development and market introduction and sales efforts. Forward-looking statements cannot be guaranteed and actual results may vary materially due to the uncertainties and risks, known and unknown, associated with such statements. We undertake no obligation to update any forward-looking statements. We wish to caution investors that the following important factors, among others, in some cases have affected and in the future could affect our actual results of operations and cause such results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by or on our behalf. It is not possible to foresee or identify all factors that could cause actual results to differ from expected or historic results. As such, investors should not consider any list of such factors to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions.

While we currently believe that we have sufficient capital, we may have other capital needs.

We again achieved positive operating cash flow in 2006 and expect it to continue to be positive in the future, provided we continue to increase revenue and manage expenses. We believe our cash reserves are sufficient to execute our strategies and are likely to increase as investor warrants are exercised. If we do not maintain positive cash flow, we may need additional capital in the form of debt or equity financing to continue to operate the business. Additional capital may be needed if there is a significant change in our business plan or operating results. There is no assurance that additional debt or equity financing will be available to us on favorable terms or at all.

We are dependent upon our new product development efforts. Additional development work is required to increase the breadth of our SmartMusic and Finale businesses and the accompaniment repertoire for SmartMusic. There can be no assurance that our timetable for any of our development plans will be achieved, that sufficient development resources will be available or that development efforts will be successful.

We are dependent upon the Internet in our business. We are dependent on the Internet to activate our SmartMusic subscriptions and secure our licensed content. We also utilize the Internet as one of our order-processing channels. Critical issues concerning the commercial use of the Internet, including security, cost, ease of use and access, intellectual property ownership and other legal liability issues, remain unresolved and could materially and adversely affect both the growth of Internet usage generally and our business in particular. If we experience problems developing and maintaining our Internet operations, our sales, operating results and financial condition could be adversely affected.

We are dependent upon obtaining and maintaining license agreements with music publishers, of which there are a limited number. The world market for music license rights is highly concentrated among a limited number of publishers. We have entered into license agreements with leading music publishers that provide access to certain musical titles for accompaniment development. Many of our contracts with major publishers are not exclusive, which means that similar agreements may be made with competitors or that the publishers themselves may sell the same titles. While we believe that our relationships with these publishers are good, there can be no assurance that we will be able to maintain or expand these relationships. The lack of a sufficient number and variety of musical arrangements would greatly limit the ability to market our products and services.

Certain of our products have limited and fluctuating sales. Sales of our SmartMusic subscription products have not achieved, and may not achieve, significant levels. Further, Internet sales have fluctuated, as have sales of Finale products, which are historically higher following the release of product upgrades. We believe that results of operations may fluctuate as a result of, among other things, the purchasing cycle of the education market and the timing of releases of new products and product upgrades. Certain states have had education funding cuts, which could negatively impact sales of products to the education market.

We have incurred operating losses in the past and may incur losses in the near future. We have incurred losses from operations and may continue to incur such losses in the near future. In order to continue to develop our business and planned product and service offerings, we will be required to devote additional amounts of capital to development and marketing efforts, among other things. There can be no assurance that we will operate profitably or provide an economic return to the investors.

We face intense competition. While competition for SmartMusic is relatively limited, there can be no assurance that in spite of significant barriers to entry that others, such as large electronic and musical instrument manufacturers, will not enter this market. Competition for our notation products could potentially adversely impact future sales levels. Our ability to continue to compete effectively will be substantially dependent upon our ability to continue to improve our product offerings and Internet resources. If such improvements and development efforts do not materialize as intended, we may lose our ability to differentiate our products from those of our competitors. In addition, increasing competition in the music software market could cause prices to fall and the volume of transactions to decline, either of which could adversely affect our business, operating results and financial condition.

Rapid technological changes and obsolescence may adversely affect our business. We operate in an industry greatly affected by technological changes. While we are not currently aware of any significant technological changes that may affect our current technology base, continued advancements in computer software, hardware and network designs and formats may impact our ability to effectively maintain our Internet-based sales efforts in a workable and user-friendly format. The proprietary technology we use to protect access to our licensed files may be effective for only a limited period by reason of technological change. We must, therefore, devote new resources to improve or modify this security system, which is a critical aspect of our ability to establish and maintain relationships with music publishers. While we currently believe that we have sufficient resources to address technological changes that may affect our business, there can be no assurance that any such technological changes will not prove too much for us to overcome in a cost-effective manner.

Additional government regulation of the Internet may impair our ability to fully develop and utilize the Internet as a marketing and distribution medium. Today, there are relatively few enacted laws specifically directed toward on-line services, and the applicability and scope of such laws is still uncertain, as court interpretations are few. Currently, we do not believe their impact materially affects the nature of our Internet operations. Applicability to the Internet of existing laws governing issues such as property ownership, copyrights, and other intellectual property issues, taxation, libel, obscenity, and personal privacy is uncertain. In addition, because our services are accessible worldwide, foreign jurisdictions may claim that we are required to comply with their laws. Laws regulating Internet companies outside of the United States may be less favorable than those in the United States.

Compliance with foreign laws may require us to change our business practices or restrict our service offerings to an extent that may damage our financial results. Further, changes to existing laws or the passage of new laws affecting the Internet could directly affect the way we do business, create uncertainty on the Internet, reduce demand for our services, increase the cost of doing business or otherwise harm our business. Our failure to comply with domestic or foreign laws could also subject us to penalties ranging from fines to bans on our ability to offer our services.

We are dependent upon certain key personnel. We are highly dependent on a limited number of key management, including our chief executive officer, and our president and chief operating officer, as

well as key technical personnel. The loss of key personnel, or our inability to hire and retain qualified personnel, could have an adverse effect on our business, financial condition and results of operations.

We are dependent upon proprietary technology and cannot assure protection of such technology. There can be no assurance that our proprietary technology will provide us with significant competitive advantages, that other companies will not develop substantially equivalent technology or that we will be able to protect our technologies. We could incur substantial costs in seeking enforcement of our patents or in defending ourselves against patent infringement claims by others. Further, there can be no assurance that we will be able to obtain or maintain patent protection in the markets in which we intend to offer products.

International development plans are subject to numerous risks. There can be no guarantee that our international expansion efforts will be successful or that we will be able to offset the cost of the resources allocated to such efforts. Moreover, we could be faced with the risks inherent in any international development, such as unpredictable changes in export restrictions, barriers and customs rates; currency risks; the difficulty of managing foreign operations; the differences in technological standards, payment terms and labor laws and practices among countries; collection problems; political instabilities; seasonal reductions in business; and unforeseen taxes. Such risk factors could harm our international operations and, therefore, our business, operating results and financial condition.

The market price of our stock may experience volatility. We cannot speculate as to the future market price of our common stock. Our common stock has experienced, and may continue to experience, significant price volatility due to a number of factors, including fluctuations in operating results, changes in market perspectives for our products, developments in our industry, and general market conditions that may be unrelated to our performance.

We will be exposed to risks relating to evaluations of controls required by Section 404 of the Sarbanes-Oxley Act. Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act and related regulations implemented by the SEC, are creating uncertainty for public companies, increasing legal and financial compliance costs and making some activities more time consuming. We will be evaluating our internal controls systems to allow management to report on, and our independent auditors to attest to, our internal controls. We will be performing the system and process evaluation and testing (and any necessary remediation) required to comply with the management certification and auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act. While we anticipate being able to fully implement the requirements relating to internal controls and all other aspects of Section 404 by our December 31, 2007 deadline, we cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, we may be subject to sanctions or investigation by regulatory authorities, including the SEC. This type of action could adversely affect our financial results or investors' confidence in our company and our ability to access capital markets and could cause our stock price to decline. In addition, the controls and procedures that we will implement may not comply with all of the relevant rules and regulations of the SEC. If we fail to develop and maintain effective controls and procedures, we may be unable to provide the required financial information in a timely and reliable manner. Further, if we acquire any company in the future, we may incur substantial additional costs to bring the acquired company's systems into compliance with Section 404.

ITEM 2. DESCRIPTION OF PROPERTY

Our corporate facility which is leased under an operating lease arrangement consists of approximately 22,000 square feet of office and warehouse space at 7615 Golden Triangle Drive, Suite M, Eden Prairie, Minnesota, 55344. Rent and maintenance payments for the remainder of the lease are approximately \$250,000 on an annual basis and the lease expires March 31, 2011.

ITEM 3. LEGAL PROCEEDINGS

In the ordinary course of business, we may be party to legal actions, proceedings or claims. Corresponding costs are accrued when it is more likely than not that loss will be incurred and the amount can be precisely or reasonably estimated. The Company is not aware of any actual or threatened litigation that would have a material adverse effect on its financial condition or results of operations.

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

None.

PART II

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

Our common stock trades on The NASDAQ Capital Market under the symbol MMUS. The following table sets forth the high and low sales prices of our common stock for the periods set forth:

| | | 2006 | | 2005 | |
|-----------------|----------------|----------|---------|---------|---------|
| | | High | Low | High | Low |
| Common Stock | First Quarter | \$ 11.80 | \$ 4.90 | \$ 5.30 | \$ 4.40 |
| | Second Quarter | 5.75 | 4.10 | 4.90 | 3.15 |
| | Third Quarter | 5.96 | 4.30 | 4.70 | 3.37 |
| | Fourth Quarter | 6.85 | 4.99 | 11.33 | 3.01 |

As of December 31, 2006, there were approximately 130 registered shareholders including approximately 1,300 beneficial owners. We have never paid cash dividends on any of our securities. We currently intend to retain any earnings for use in operations and do not anticipate paying cash dividends in the foreseeable future.

There were no sales of unregistered securities during the year ended December 31, 2006.

Pursuant to the exercise of warrants by certain warrant holders, we issued 31,250 shares of common stock at \$3.20 per share to one person on February 7, 2006, 47,578 shares of common stock at \$0.50 per share to four people between January 31, 2006 and September 27, 2006 and 7,813 shares of common stock at \$3.20 per share to one person on November 8, 2006. For all issuances, we relied upon Section 4(2) of the Securities Act for an exemption for transactions not involving a public offering.

For information on our equity compensation plans, refer to Item 11, "Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters."

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Executive Overview

MakeMusic's mission is to enhance and transform the experience of making, teaching and learning music and we intend to achieve significant growth as a worldwide leader in music education software. Among our leading products are SmartMusic®, a complete music education software for band, jazz band, orchestra and choir and Finale® music notation software.

Our fiscal year 2006 resulted in continued sales growth for both SmartMusic and Finale products and overall, a 10% increase over 2005 net revenue was achieved. Gross margin percentages improved in 2006 to 86% from 82% in 2005. Operating expenses increased in 2006, primarily due to stock-based compensation expenses and costs associated with severance, marketing activities and product development.

As a result of the factors mentioned, we reported net income of approximately \$255,000 in 2006 compared to a net loss of \$498,000 in 2005. Reductions in other general and administrative expense categories slightly offset these charges.

We believe our innovative products will allow us to continue to achieve positive operating results. For more than fifteen years, Finale has been the best-selling music notation software. It has transformed the process by which composers, arrangers, musicians, teachers, students and publishers create, edit, audition, print and publish musical scores. In the world of music software, Finale is the equivalent of Adobe® PageMaker® or Adobe® Illustrator® – it is what musicians use for page layout of sheet music. An additional feature of Finale is its ability to create SmartMusic files so that an educator/composer can create customized practice assignments for their students. We have traditionally derived revenue through the development, marketing and sales of our notation software products. Sales of these products continue to grow through regular upgrade releases, extension into a family of notation products with reduced features and appropriate pricing to appeal to new market segments and distribution channels and natural renewal in the education market.

SmartMusic is a complete, interactive, computer-based practice system for woodwind, string and brass players and vocalists. SmartMusic enhances and transforms the process of practicing music by accompanying musicians and students while they practice – following their spontaneous tempo changes like a human accompanist. SmartMusic is a complete teaching and learning tool for band, orchestra and choir. Offered through subscription, SmartMusic gives musicians access to a library of more than 30,000 professionally performed and recorded accompaniments, more than 50,000 exercises, and the ability to receive and submit assignments received from their instructor.

The SmartMusic assessment and recording features allow real-time feedback for students of all ages. These features provide music educators the ability to create SmartMusic assignments and require students to submit a recording of their performance including the assessment of the assignment. Students see their assessment scores immediately and are motivated to improve their performance prior to submitting the assignment. Similarly, students can make as many recordings of their performance as desired prior to submitting assignments. This combined feedback helps students improve on their own and understand how they are progressing.

SmartMusic is becoming a very important part of our business with recurring revenue from the subscription-based model that leverages our relationships with music educators and their students. We continue to fine-tune the model to ensure strong acceptance of the SmartMusic subscription service and have experienced consistent annual increases in subscriptions and revenue. Due to alliances with industry leading partners such as Hal Leonard and Conn-Selmer, as well as partnerships such as the International Trombone Association and the North American Saxophone Alliance we expect to see growth opportunities in 2007 and in future years. While it is difficult to predict the volume increase these alliances may generate, we are confident that we will be ready for the challenges this growth may present.

The Company is planning to release SmartMusic 10.0 in the first half of 2007. Offering full support of core curriculum titles for band, jazz ensemble, orchestra and choir – as well as pre-authored assignments for every title – SmartMusic 10.0 represents a complete solution for music educators.

SmartMusic 10.0 which is scheduled to be released in the first half of 2007 will also include SmartMusic Impact™, a web-based service designed to manage student assignments, grades and recordings while documenting the progress of each student. The introduction of SmartMusic 10.0 will provide music educators (and students) with exciting new possibilities to assist in developing strong music programs and complying with accountability requirements. SmartMusic 10.0 will provide access to an ever increasing library of band and orchestra literature. Each title includes individual part assignments authored by respected educators thereby providing music teachers a time saving solution for preparing selections for the next public performance. SmartMusic Impact will enable teachers to easily send assignments to each of their students. Students complete the assignment on their home computer provided that they have a SmartMusic subscription, or on a school computer equipped with SmartMusic. Submitted assignments are automatically graded and posted in the teachers SmartMusic Impact gradebook.

With the release of SmartMusic Impact in 2007, the Company will begin tracking teachers that use SmartMusic as well as the percentage of those teachers that are using Impact to deliver and manage student assignments (Impact teachers), and the average number of students each Impact teacher has.

With Finale and SmartMusic, we believe we have the platforms for building continued growth in the music education software industry. We are exploring opportunities to introduce our existing products into new geographic markets through existing distribution partners and new relationships. We are also exploring opportunities to develop and launch new products based on our core music education technologies: the editing, display, printing and playback of music notation, pitch recognition, assessment, recording and Intelligent Accompaniment.

Positive cash flow from operations has been achieved for the last three years including the current year ended December 31, 2006. With increased revenues and, in particular, the growth in SmartMusic subscriptions, plus improvements in efficiency over the last few years, we feel that we can continue to achieve positive operating cash flow on an annual basis in the future. In spite of tight budgets in the school systems, we are confident that we can continue to move toward annual profitability due to our improvements in operations, established customer base and partnerships within the music industry and education providers.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles. The preparation of these financial statements requires management to make significant 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 periods presented. We believe that the following are some of the more critical judgment areas in the application of our accounting policies that currently affect our financial position and results of operations.

Revenue recognition. Software revenue is recognized in accordance with the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition*, when all of the following conditions are met: there is evidence of an agreement with the customer (normally a purchase order), delivery has occurred, the total sales price is fixed and determinable, collectability is probable and any uncertainties with regard to customer acceptance are insignificant. If a customer is entitled to a pending upgrade, a portion of the revenue is deferred until delivery of the upgrade. For any sales that include a right of return, we track return history and record a reduction to revenue for the estimated return amount in accordance with Financial Accounting Standards Board ("FASB") Statement 48 ("FAS 48"), *Revenue Recognition When a Right of Return Exists*. SmartMusic subscription sales are deferred and amortized to revenue on a pro-rated basis over the life of the subscription.

Allowance for doubtful accounts. Our distribution in domestic and international markets through independent dealers and distributors concentrates relatively large amounts of receivables in relatively few customer accounts; however, none are greater than 10% of the total revenue. Most international customers pay for the product in U.S. dollars prior to shipment; domestic dealers and distributors that do not prepay are granted payment terms and credit limits based on credit checks and account history. We have successfully done business with most of our dealers and distributors for many years and until fiscal year ended December 31, 2006 had a history of minimal uncollectible accounts. During fiscal year ended December 31, 2006 the allowance for doubtful accounts was increased for two music retail customers that filed for bankruptcy protection during the year and an additional customer that had ceased further payments due to deterioration in its business.

Any sales directly to home users are prepaid and schools submit purchase orders for purchases. The Company records a monthly accrual for potential non-payments, which has historically been sufficient to cover uncollected accounts. Financial conditions in international markets can change very quickly and our allowance for doubtful accounts cannot anticipate all potential changes.

Sales returns and allowance reserve. SmartMusic teacher subscriptions automatically renew at the end of their subscription period. Notices of renewal are sent to the teacher in advance and an invoice is sent upon the renewal date. A reserve is booked for those subscriptions that automatically renew and are subsequently cancelled due to teacher relocation, teacher cancellation or non-payment of accounts. The reserve represents 100% of all unpaid invoices for SmartMusic subscriptions which are more than six months overdue and which have had no activity in the preceding six months. The reserve is then evaluated quarterly to determine if any adjustments are necessary.

Inventory valuation. Inventories are stated at the lower of cost or market, with cost being determined on a weighted average cost method. We record a provision to adjust slow-moving and obsolete inventories to the lower of cost or market based on historical experience and current product demand. The carrying value of inventory is evaluated at least quarterly and adjusted as needed. Inventory is reviewed for obsolescence when the inventory is no longer used in a current build cycle. The amount of obsolescence is determined at that time as follows: 50% of the cost of stock on hand is reserved in the year immediately following inclusion in a build cycle and 100% is reserved in the second year following inclusion in a build cycle.

Prepaid licensing reserves. Our business requires licensing rights to certain technologies and songs that are used in our product. Many publishers require advance payments in order to license their property, which we record as prepaid royalties. We periodically analyze the prepayments to estimate the likelihood that we will fully realize the value of the advance royalties on each song. A reserve is recorded and evaluated for the prepaid royalty asset to estimate the amount that may not be realized.

Capitalized software costs. Costs incurred in the development of software products are capitalized in accordance with the FASB Statement 86 ("FAS 86"), *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, which requires the capitalization of certain software development costs incurred after technological feasibility is established. Technological feasibility is established when all planning and testing activities are completed. Capitalization of computer software costs shall cease when a product is available for general release to customers. We capitalize the costs of producing SmartMusic products and individual song titles to be included as repertoire with the SmartMusic product. Upon release of a song, we amortize the costs over the estimated life of the song, not to exceed three years. A reserve is recorded for an estimate of song titles that will not be released. Annual development of notation products consists of maintenance costs that are expensed as incurred.

Post contract support. We account for software maintenance in accordance with AICPA SOP 97-2, *Software Revenue Recognition* which states that revenue for post contract support (PCS) may be recognized upon the initial sale when PCS is included with the initial license and the cost of providing PCS during the arrangement is insignificant. However the estimated related costs are accrued in the same period that the sales price is recognized. We provide unlimited, free telephone and email technical support to our customers and, therefore, accrue an estimated cost of future support in the period of sale.

Impairment of goodwill. We review goodwill for potential impairment at least annually or when events or changes in circumstances indicate the carrying value of goodwill may be impaired. We utilize an analysis of the public market value of our stock to assess whether the asset's carrying value is fully recoverable. The assessment of potential impairment requires certain judgments and estimates by us, including the determination of an event indicating impairment, the future cash flows to be generated by assets of the company, the risks associated with those cash flows and the discount rate to be utilized. If actual results are not consistent with our assumptions, we may be required to record a goodwill impairment charge.

Deferred tax assets. We have U.S. net operating loss carry-forwards of approximately \$20.8 million, and tax credits of approximately \$875,000. The losses and tax credits are carried forward for Federal and state corporate income taxes and may be used to reduce future taxes. At December 31, 2006, we had net deferred tax assets totaling approximately \$9.1 million. However, since we currently could not conclude that this net asset is more likely than not to be realized we have recorded a valuation allowance for its full amount.

Results of Operations

The following table summarizes key operating information for the years ended December 31, 2006, and 2005.

| | 12 Months Ended December 31, | | | |
|------------------------------------|------------------------------|---------|-------------------|------|
| | 2006 | 2005 | Incr (Decr) | % |
| | (In \$ thousands) | | (In \$ thousands) | |
| Notation revenue | \$10,267 | \$9,740 | \$527 | 5% |
| SmartMusic revenue | 2,164 | 1,567 | 597 | 38% |
| Other revenue | 547 | 510 | 37 | 7% |
| Net revenue | 12,978 | 11,817 | 1,161 | 10% |
| Cost of revenues | 1,847 | 2,185 | (338) | -15% |
| Gross profit | 11,131 | 9,632 | 1,499 | 16% |
| Percentage of net sales | 86% | 82% | | |
| Development expenses | 3,474 | 3,279 | 195 | 6% |
| Selling and marketing expense | 4,114 | 3,882 | 232 | 6% |
| General and administrative expense | 3,388 | 3,000 | 388 | 13% |
| Total operating expense | 10,976 | 10,161 | 815 | 8% |
| Operating income (loss) | 155 | (529) | 684 | 129% |
| Other income (expense) | 109 | 32 | 77 | 241% |
| Net income (loss) before taxes | \$264 | (\$497) | \$761 | 153% |
| Income tax provision | (9) | (1) | (8) | 800% |
| Net income (loss) | \$255 | (\$498) | \$753 | 151% |

Year ended December 31, 2006, compared to the year ended December 31, 2005

Net revenue. Net revenue increased 10% from \$11,817,000 in 2005 to 12,978,000 in 2006.

Notation revenue increased \$527,000 from the prior year to \$10,267,000 for the year ended December 31, 2006 primarily due to the strong performance of Finale 2007 which began shipping in August 2006. This release of the Finale software has proven to be the best selling in our history in terms of both upgrades and new product sales, surpassing even the record release for Finale 2006

The increase in SmartMusic revenue reflects the growth of the SmartMusic subscription system that was originally launched in 2001. SmartMusic is sold to schools, students and music organization members on a subscription basis. Revenue for these subscriptions is recognized over the life of the subscription which is typically 12 months. Total earned SmartMusic revenue for the year ended December 31, 2006, was \$2,164,000, an increase of \$597,000, or 38%, over the year ended December 31, 2005. Total unearned SmartMusic subscription revenue (deferred revenue) was 1,094,000 as of December 31, 2006, an increase of \$259,000, or 31%, over the balance at December 31, 2005. We are currently focusing specific marketing activities in this area and anticipate continued growth in the number of subscriptions in the future.

SmartMusic subscriptions have shown sustained growth since its launch. More than 5,850 schools have purchased SmartMusic, an increase of 30% over the 4,500 schools that had purchased it as of December 31, 2005 and the program currently represents 18,660 subscriptions. The school and association

sponsored subscription program grew to over 35,570 subscriptions as of December 31, 2006, and individual subscriptions grew to 2,470. Total SmartMusic subscription count was approximately 56,700 as of December 31, 2006, an increase of 24% compared to 45,600 as of December 31, 2005.

Starting late in 2006, we began actively promoting the 2007 availability of SmartMusic 10.0 and SmartMusic Impact™, a web-based service that is being designed to manage student assignments, recordings and grades while documenting the progress of each student. SmartMusic 10.0 and SmartMusic Impact™ are expected to be released sometime in the first half of 2007. We are demonstrating these products as the Company's complete solution for music educators at major education conferences and clinics. An accelerated rate of SmartMusic subscriptions is anticipated starting in the fall of 2007 with back to school teacher purchases.

With the release of SmartMusic Impact, we will begin tracking teachers that use SmartMusic as well as the number of those teachers that are using Impact to deliver and manage student assignments (Impact teachers), and the average number of students subscriptions per Impact teacher.

Many SmartMusic customers, especially new customers, also purchase accessories (primarily microphones and foot pedals) that are used with the software. Revenue for the sales of accessories, included in the SmartMusic revenue category, for the year ended December 31, 2006, was \$510,000, which was \$149,000, or 41%, greater than revenue of \$361,000 for SmartMusic accessories in the year ended December 31, 2005.

Gross profit. Gross profit increased by \$1,499,000 from \$9,632,000 for the year ended December 31, 2005 to \$11,131,000 for the year ended December 31, 2006 due to the increase in revenue and a higher gross margin percentage. Gross margin percentages improved 4% primarily due to the expiration of a patent-based royalty payment and completion of software amortization related to the reverse merger that occurred in 2000 which was \$407,000 for the twelve months ended December, 31, 2005 and \$0 for the twelve months ended December 31, 2006. Cost of revenue includes product costs, royalties paid to publishers, amortization of capitalized notation, repertoire and SmartMusic software development costs and credit card fees. Gross margin as a percentage of revenue was approximately 86% and 82% for the periods ended December 31, 2006 and 2005, respectively.

Development expense. Development expenses increased by \$195,000 in 2006 to \$3,474,000 but actually decreased by 1% as a percent of revenue. Development expenses consist primarily of Finale notation and SmartMusic product development as well as SmartMusic repertoire development, business systems and quality assurance. Personnel and contract labor costs increased from the prior year due to staff increases in order to achieve numerous product development goals. Content development expenditures of \$247,000 in 2006 and \$287,000 in 2005 related to additional SmartMusic repertoire have been capitalized and are being amortized over their estimated useful life of 3 years. In addition, during 2006, \$403,000 of development expenditures were capitalized related to costs to develop the SmartMusic Impact application. No development expenditures were capitalized related to SmartMusic Impact in 2005. Development expenses are expected to increase in 2007 as compared to 2006 as the Company intends to continue developing and enhancing products.

Selling and marketing expense. Selling and marketing expenses primarily consist of marketing, advertising and promotion expenses, business development and customer service activities and payroll. Sales and marketing expenses increased by \$232,000, or 6% in 2006 compared to 2005 but actually decreased as a percent of revenue by 1%. The increase is primarily related to increases in marketing personnel and marketing programs. Marketing expenses are expected to increase in 2007 as compared to 2006 as we plan to ramp-up promotional activities for SmartMusic 10.0 and SmartMusic Impact and strengthen marketing efforts through the introduction of a SmartMusic advocate program and establishment of SmartMusic as the standard for auditions.

General and administrative expense. General and administrative expenses consist primarily of payroll and related expenses for executive and administrative personnel, professional services, facility costs, amortization of certain intangible assets with finite lives, bad debt and other general corporate

expenses. General and administrative expenses increased by \$388,000, or 13%, in 2006 compared to 2005. The increase was primarily due to \$156,000 in non-cash stock-based compensation resulting from stock option expensing under SFAS 123(R), which was implemented in the first quarter of 2006 and approximately \$200,000 of additional compensation related to severance costs to our former CEO and CFO. We also recorded \$180,000 in bad debt expense during 2006 as a result of two music retail customers that filed for bankruptcy protection during the year and establishing a reserve for an additional customer that had ceased further payments due to deterioration in its business. Net reductions in other administrative expenses totaled approximately \$148,000 in 2006.

Interest income and expense, net. Net interest income was \$93,000 for the year ended December 31, 2006, compared to \$29,000 in net interest income for the year ended December 31, 2005. The increase in net interest income was due to higher interest rates and a higher average balance of cash deposited in interest-bearing accounts during the year.

Other Income. In 2006, we recognized \$14,000 in gain from the sale of investments. No such gains were recognized in 2005.

Income tax. Due to operating losses, we recorded only the minimum taxes due for the years ended December 31, 2006 and 2005. Because the Company could not currently determine that it is more likely than not that the operating loss carry-forwards will be realized, there is no tax benefit for losses incurred reflected in the financial statements.

Liquidity and capital resources. Cash flow from operating activities was \$1,147,000 in the year ended December 31, 2006 compared to \$451,000 in the year ended December 31, 2005, an increase of \$696,000. Actual cash used in operations is typically highest in the first and second quarter, with the third and fourth quarters normally producing positive operating cash flow. These quarterly fluctuations are created by the notation product release cycle and the cyclical impact of sales to schools related to the school year fiscal calendar. Management expects to achieve positive annual cash flow in the foreseeable future but not, necessarily, in each quarter. If we do not meet our anticipated revenue levels due to a significantly later-than-anticipated product release or a decrease in demand for our products, management is committed to expense reductions as necessary to ensure adequate cash levels remain to continue funding operations. If further expense reductions do not offset this decrease in revenue, we may have to seek additional financing. There can be no assurances, however, that such financing will be available under attractive terms or at all.

Cash used in investing activities was \$1,199,000 in the year ended December 31, 2006, compared to \$539,000 in the year ended December 31, 2005. Current year expenditures were \$552,000 for purchases of property and equipment and \$650,000 for capitalization of software development, primarily for SmartMusic Impact and repertoire development.

Cash provided by financing activities was \$230,000 in the year ended December 31, 2006, compared to \$825,000 in the year ended December 31, 2005. The decrease in cash from financing activities in 2006 is attributable to less cash received from the exercise of stock options and warrants primarily as a result of a more stable stock price during 2006 as compared to 2005.

As of December 31, 2006, we had cash and cash equivalents of \$3,130,000 and as of December 31, 2005 the balance was \$2,952,000.

New accounting pronouncements. Refer to Note 3 in the audited financial statements.

ITEM 7. FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
MakeMusic, Inc.
Eden Prairie, Minnesota

We have audited the accompanying consolidated balance sheets of MakeMusic, Inc. and subsidiaries, as of December 31, 2006, and 2005 and the related consolidated statements of operations, shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of MakeMusic, Inc. and subsidiaries as of December 31, 2006, and 2005 and the consolidated results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

As described in Note 2 to the financial statements, effective January 1, 2006 the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*.

/s/ McGladrey & Pullen LLP

Minneapolis, Minnesota
March 16, 2007

MakeMusic, Inc.
Consolidated Balance Sheets

(In thousands of U.S. dollars, except share and per share data)

| | December 31 | |
|--|--------------------|-------------|
| | 2006 | 2005 |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$3,130 | \$2,952 |
| Accounts receivable (net of allowance of \$149 and \$15 in 2006 and 2005, respectively) | 1,664 | 1,004 |
| Inventories | 347 | 435 |
| Prepaid expenses and other current assets | 199 | 161 |
| Total current assets | 5,340 | 4,552 |
| Property and equipment, net | 663 | 323 |
| Capitalized software products, net | 954 | 471 |
| Goodwill, net | 3,630 | 3,630 |
| Other non-current assets | 39 | 66 |
| Total assets | \$10,626 | \$9,042 |
| Liabilities and shareholders' equity | | |
| Current liabilities: | | |
| Current portion of capital lease obligations | \$10 | \$6 |
| Accounts payable | 507 | 441 |
| Accrued compensation | 1,066 | 681 |
| Other accrued liabilities | 254 | 164 |
| Post contract support | 181 | 181 |
| Reserve for product returns | 429 | 339 |
| Current portion of deferred rent | 25 | 20 |
| Deferred revenue | 1,199 | 916 |
| Total current liabilities | 3,671 | 2,748 |
| Capital lease obligations, net of current portion | 15 | 9 |
| Deferred rent, net of current portion | 96 | 120 |
| Shareholders' equity: | | |
| Common stock, \$0.01 par value: | | |
| Authorized shares – 10,000,000 | | |
| Issued and outstanding shares – 3,971,229 and 3,856,654 in 2006 and 2005, respectively | 40 | 39 |
| Additional paid-in capital | 62,896 | 62,459 |
| Accumulated deficit | (56,092) | (56,347) |
| Other comprehensive income | 0 | 14 |
| Total shareholders' equity | 6,844 | 6,165 |
| Total liabilities and shareholders' equity | \$10,626 | \$9,042 |

See accompanying notes.

MakeMusic, Inc.
Consolidated Statements of Operations
(In thousands of U.S. dollars, except share and per share data)

| | Year | |
|---|---------------------------|-------------|
| | Ended December 31, | |
| | 2006 | 2005 |
| Revenues: | | |
| Notation revenue | \$10,267 | \$9,740 |
| SmartMusic revenue | 2,164 | 1,567 |
| Other revenue | 547 | 510 |
| NET REVENUES | 12,978 | 11,817 |
| | | |
| COST OF REVENUES | 1,847 | 2,185 |
| | | |
| GROSS PROFIT | 11,131 | 9,632 |
| | | |
| OPERATING EXPENSES: | | |
| Development expenses | 3,474 | 3,279 |
| Selling and marketing expenses | 4,114 | 3,882 |
| General and administrative expenses | 3,388 | 3,000 |
| | | |
| Total operating expenses | 10,976 | 10,161 |
| | | |
| INCOME (LOSS) FROM OPERATIONS | 155 | (529) |
| | | |
| Interest income | 94 | 34 |
| Interest expense | (1) | (5) |
| Other income, net | 16 | 3 |
| | | |
| Income (Loss) before income tax | 264 | (497) |
| Income taxes | 9 | 1 |
| | | |
| Net Income (Loss) | 255 | \$(498) |
| | | |
| Income (Loss) per common share: | | |
| Basic | 0.07 | (0.14) |
| Diluted | 0.06 | (0.14) |
| | | |
| Weighted average number of common shares outstanding: | | |
| Basic | 3,916,578 | 3,520,130 |
| Diluted | 4,551,031 | 3,520,130 |

See accompanying notes.

MakeMusic, Inc.
Consolidated Statement of Shareholders' Equity
(In thousands of U.S. dollars, except share data)

| | Common Stock | | Additional Paid-In Capital | Accumulated Deficit | Accumulated Other Comprehensive Income | Shareholders' Equity (Deficit) |
|--|------------------|-------------|----------------------------------|------------------------|---|--------------------------------------|
| | Total Shares | Amount | | | | |
| Balance at December 31, 2004 | 3,419,464 | \$34 | \$61,626 | (\$55,849) | \$0 | \$5,811 |
| Exercise of stock options and warrants | 437,190 | 5 | 826 | - | - | 831 |
| Issuance of stock, stock options and warrants for services | - | - | 7 | - | - | 7 |
| Comprehensive Income: Unrealized gain on marketable securities | - | - | - | - | 14 | 14 |
| Net loss | - | - | - | (498) | - | (498) |
| Balance at December 31, 2005 | 3,856,654 | \$39 | \$62,459 | (\$56,347) | \$14 | \$6,165 |
| Exercise of stock options and warrants | 114,575 | 1 | 238 | - | - | 239 |
| Compensation under FAS123(R) | - | - | 189 | - | - | 189 |
| Issuance of stock, stock options and warrants for services | - | - | 10 | - | - | 10 |
| Comprehensive Income: Realized loss on marketable securities | - | - | - | - | (14) | (14) |
| Net Income | - | - | - | 255 | - | 255 |
| Balance at December 31, 2006 | 3,971,229 | \$40 | \$62,896 | (\$56,092) | \$0 | \$6,844 |

See accompanying notes.

MakeMusic, Inc.
Consolidated Statements of Cash Flows
(In thousands of U.S. dollars)

| | Year Ended | Year Ended |
|--|-------------------|-------------------|
| | 2006 | 2005 |
| Operating activities | | |
| Net Income/(loss) | \$255 | \$(498) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Amortization of intangible assets | 0 | 725 |
| Depreciation and amortization of property, equipment and capitalized software | 414 | 325 |
| Loss (Gain) on disposal of property and equipment | (11) | 21 |
| Issuance of options and warrants for services | 199 | 7 |
| Net changes in assets and liabilities: | | |
| Accounts receivable | (660) | (174) |
| Inventories | 88 | (103) |
| Prepaid expenses and other current assets | (33) | 111 |
| Accounts payable | 66 | (53) |
| Accrued liabilities and product returns | 546 | (129) |
| Deferred revenue | 283 | 219 |
| Net cash provided by operating activities | 1,147 | 451 |
| Net cash used in investing activities | | |
| Purchases of property and equipment | (552) | (255) |
| Proceeds from disposal of property and equipment | 3 | 5 |
| Capitalized development and other intangibles | (650) | (289) |
| Net cash used in investing activities | (1,199) | (539) |
| Net cash provided by financing activities | | |
| Proceeds from stock options and warrants exercised | 239 | 831 |
| Payments on long-term debt and capital leases | (9) | (6) |
| Net cash provided by financing activities | 230 | 825 |
| Net increase in cash and cash equivalents | 178 | 737 |
| Cash and cash equivalents, beginning of year | 2,952 | 2,215 |
| Cash and cash equivalents, end of year | \$3,130 | \$2,952 |
| Supplemental disclosure of cash flow information | | |
| Interest paid | 1 | 5 |
| Taxes paid | 9 | 0 |
| Other non-cash investment and financing activities | | |
| Equipment acquired under capital lease | 29 | 0 |

See accompanying notes.

Notes to Consolidated Financial Statements

1. Description of Business

The Company develops and markets proprietary music technology products under the Finale® and SmartMusic® brands that enhance music learning and composition, increase productivity and make practicing and performing music fun. The Company's innovative products provide easy-to-use, efficient alternatives to traditional practice, education and composition techniques. Software product sales are made through traditional distribution channels and the Company's websites.

2. Summary of Significant Accounting Policies

Consolidation

The consolidated financial statements include the accounts of MakeMusic, Inc., or predecessors. During 2006 the Company dissolved its subsidiaries which had been inactive in 2005, and as such, there are no inter-company transactions which require elimination for the year ended December 31, 2006 and 2005.

Revenue Recognition

Revenue for notation products is recognized when goods are shipped or delivered. SmartMusic subscription revenue is recognized over the lives of the subscriptions. Software revenue is primarily derived from the sale of "off the shelf" products, easily installed and used by the customer. Software revenue is recognized in accordance with the AICPA SOP 97-2, *Software Revenue Recognition*, when all of the following conditions are met: there is evidence of an agreement with the customer (normally a purchase order), delivery has occurred, the total sales price is fixed and determinable, collection is probable and any uncertainties with regard to customer acceptance are insignificant. For our bundled products, we recognize revenue based on Vendor Specific Objective Evidence (VSOE) of fair value of the individual components.

Customers are entitled to a free upgrade if the Company launches a new version of a software product within a specified period after a customer originally purchased their software. In this event, the Company defers a portion of the sale price applicable to the upgrade for products sold within the upgrade replacement window until such time that the upgrade is shipped.

When a new version of Finale is released, dealers retain the right to return any unsold versions of the prior release (normally 10% of total prior year sales) in exchange for an equal number of units of the updated version of the product that is returned. The Company tracks the history of these returns and defers revenue based on the expected return rate until the new product is released, at which time the product may be returned for credit provided the customer places an equivalent (number of units) order for the new version.

Shipping and handling charges are accounted for in accordance with EITF No. 00-10, *Accounting for Shipping and Handling Fees and Costs*, with all charges to customers for shipping and handling included in revenues and all costs in cost of revenues. Revenue for the years ended December 31, 2006, and 2005 include \$547,000 and \$510,000 of shipping and handling revenue, respectively. Cost of revenue for the years ended December 31, 2006 and 2005 include \$392,000 and \$372,000 of shipping expense, respectively.

2. Summary of Significant Accounting Policies (Continued)

Net Income (Loss) Per Share

For year ended December 31, 2006 basic net income per common share was computed by dividing net income by the weighted average number of common shares outstanding during the year, including potentially dilutive shares such as options and warrants to purchase shares of common stock at various amounts per shares (Note 6). The dilutive affect of the additional shares for the year ended December 31, 2006 was to increase the weighted average shares outstanding by 634,453.

For year ended December 31, 2005 basic and diluted net loss per common share was computed by dividing the net loss by the weighted average number of common shares outstanding during the year. The effect of options and warrants are excluded from diluted shares for 2005 as their effect would be anti-dilutive

Segment Reporting

The Company operates in one industry segment; the design, development, support and marketing of application software solutions to music educators, music-makers and the music publishing industry. Product distribution is carried out via the Internet as well as through a variety of strategic partnerships and distribution networks in the United States and many foreign countries. See Note 11 for geographic data.

Cash and Cash Equivalents

Cash equivalents consist of money market instruments with original maturities of 90 days or less. Cash equivalents are recorded at cost, which approximates fair value.

Fair Value of Financial Instruments

At December 31, 2006, and 2005, the carrying values of current financial instruments such as cash and cash equivalents, accounts receivable, accounts payable, other current assets, accrued liabilities and other current liabilities approximated their market values based on the short-term maturities of these instruments. Investments were carried at their quoted market value. At December 31, 2005 the Company had an investment in a marketable equity security with a fair value of approximately \$14,000 which was included as a component of other current assets. The investment was classified as available for sale and as such, unrealized gains and losses are included in other comprehensive income. During 2006, this investment was liquidated and as of December 31, 2006, the company had no short or long terms investments.

Accounts Receivable

Accounts receivable are recorded for all credit sales at the time the products are shipped to the customers. Credit terms for dealers and distributors are generally net 30 days and are granted on the basis of credit references and payment history. Certain large volume dealers and distributors are granted payment terms of 60 days. Schools submit purchase orders for shipments with payment due in 30 days. Sales to individuals are paid prior to shipment with a credit card or prepayment with the order. Payments not received within the agreed upon terms are considered past due.

The Company maintains an allowance for doubtful accounts based on bad debt history and analysis of specific past due accounts. Analysis of the customers' ability to pay includes contact through statements, e-mail and telephone as well as consideration of the customers' payment history. If the analysis indicates any customers are unlikely to pay, the accounts are written off against the allowance for doubtful accounts and sent to collections.

2. Summary of Significant Accounting Policies (Continued)

Inventories

Inventories are stated at the lower of weighted average cost or market and consist of finished products and components, net of a reserve for obsolescence. The Company determines its obsolescence reserves quarterly.

Property and Equipment

Property and equipment are stated at their acquisition costs net of accumulated depreciation. Depreciation is computed by using the straight-line method over the estimated useful lives of the purchased software (three years), computer equipment (three years), and furniture (five years).

Property and equipment held under capital leases are capitalized and depreciated over the useful life of the asset, in case of a contractual option to buy, or over the residual life of the lease contract.

Capitalized Software Products

Capitalized software products consist of expenditures to develop software products for sale, including repertoire software and website development.

Product development. Costs incurred in the development of software products are capitalized in accordance FAS 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. The Company periodically evaluates whether events and circumstances have occurred that indicate the remaining balance of capitalized software development costs may not be recoverable.

Costs capitalized in accordance with FAS 86 for the development of the Company's SmartMusic Impact application, as of December 31, 2006 and 2005, net of amortization and reserves were \$403,000 and \$0 respectively. The capitalized amount represents costs of developing the SmartMusic Impact interface to the SmartMusic application as technological feasibility had been established through the successful selling of the core SmartMusic application. The Company periodically evaluates whether events and circumstances have occurred that indicate the remaining balance of capitalized software development costs may not be recoverable. In the years ended December 31, 2006 and 2005, the company determined that no impairment had occurred related to the SmartMusic Impact application. The Company will begin amortization of these costs when the product is released for sale.

As of December 31, 2006, and 2005, costs capitalized for the development of the Company's repertoire software, net of amortization and reserves were \$549,000 and \$464,000, respectively. The capitalized amount represents costs of producing product masters for new songs as technological feasibility had been established by the selling of previous titles. When a title is available for release, expenditures related to that title are no longer capitalized and the capitalized cost of the title is amortized over a three-year period using the straight-line method. The Company periodically evaluates whether events and circumstances have occurred that indicate the remaining balance of capitalized repertoire development costs may not be recoverable. For the year ended December 31, 2006 and 2005, amortization was \$165,000 and \$159,000, respectively.

Goodwill

Goodwill represents the cost in excess of fair value of the tangible and identified intangible assets of businesses acquired. In accordance with FASB Statement 142 ("FAS 142"), *Goodwill and Other Intangible Assets*, goodwill is not amortized but rather is reviewed for impairment annually in the fourth quarter of the Company's fiscal year, or more often if indicators of impairment exist (see Note 4).

2. Summary of Significant Accounting Policies (Continued)

Other Intangible Assets

Other intangible assets consist primarily of the identifiable intangible assets acquired in the 2000 reverse merger between Coda Music Technology, Inc. and Net4Music S.A. (see Note 4) and include: the value of the notation and SmartMusic software products which was amortized over five years; Coda trade name, which was being amortized over ten years; Coda website which was amortized over three years; distributor/dealer network which was amortized over five years; and customer lists which were amortized over five years. As of December 31, 2005, all other intangible assets related to the 2000 reverse merger were fully amortized.

Patents and trademarks

Costs associated with obtaining patents, trademarks and Internet domain names are capitalized and are included in other non-current assets on the Balance Sheet. These costs are being amortized from three to ten years depending on their estimated useful lives and are included in other assets on the balance sheet. Costs of maintaining patents and trademarks after acquisition are expensed as incurred.

Impairment of Long-Lived Assets

The Company reviews its long-lived assets for impairment when events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If impairment indicators are present and the estimated undiscounted cash flows are less than the carrying value of the assets, the carrying value is reduced to the estimated fair value as measured by the discounted cash flows.

Leases

Leases are capitalized in accordance with FASB Statement 13, *Accounting for Leases*, which specifies that in a lease that transfers the benefits and risks inherent in the ownership of property to the lessee, the lessee should account for the lease as the acquisition of an asset and the incurrence of a liability. The Company includes capital lease assets in its property and equipment and records the liabilities as capital lease obligations on the balance sheet.

Income Taxes

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss or tax credit carry-forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the amounts of assets and liabilities recorded for income tax and financial reporting purposes. Deferred tax assets are reduced by a valuation allowance when management determines that it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and tax rates on the date of enactment.

Stock-Based Compensation

The Company currently offers a stock based compensation plan to its employees, board members and consultants. This plan is administered by the compensation committee of the Board of Directors, which recommends to the Board persons eligible to receive awards and the number of shares and/or options subject to each award, the terms, conditions, performance measures, and other provisions of the award. Readers should refer to Note 6 for additional information related to the Company's stock based compensation plans.

Effective January 1, 2006, the Company adopted SFAS No. 123 (revised), "Share-Based Payment" (SFAS 123(R)), utilizing the modified prospective approach. Prior to the adoption of SFAS 123(R) the Company accounted for incentive stock option grants in accordance with APB Opinion No. 25,

2. Summary of Significant Accounting Policies (Continued)

“Accounting for Stock Issued to Employees” (the intrinsic value method), and accordingly, recognized no compensation expense for stock option grants. Under the modified prospective approach, SFAS 123(R)

applies to new awards and to awards that were outstanding on January 1, 2006 that are subsequently modified, repurchased or cancelled. Under the modified prospective approach, compensation cost recognized in fiscal 2006 includes compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and compensation cost for all share-based payments granted subsequent to January 1, 2006 based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). Prior periods were not restated to reflect the impact of adopting the new standard.

As a result of adopting SFAS 123(R) on January 1, 2006, for the twelve months ended December 31, 2006, the Company’s income before taxes and net income decreased \$189,000 related to stock compensation expense.

Generally, the Company would receive a tax deduction for nonqualified stock option exercises during the period when the options are exercised for the excess of the market price when the options are exercised over the grant prices of the options. Prior to adoption of SFAS 123(R), these tax benefits would have been reported as operating cash flows in the Company’s consolidated statements of cash flows. Under SFAS 123(R), the Company is required to present these tax benefits as financing cash flows. The Company had no reported tax benefits related to stock compensation expense prior to the implementation of SFAS 123(R) on January 1, 2006.

During the first year of implementation of SFAS 123(R), the Company is required to choose a method to calculate the pool of windfall tax benefits. The pool represents the differences between book and tax treatment related to stock compensation prior to the implementation of SFAS 123(R). The FASB has allowed two methods which Company’s can use to calculate their pool as denoted in *FASB Staff Position No. SFAS 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*. The methods offered by the FASB are the *long-form* method and the *short-cut* method. After evaluating both methods, the Company elected the short-cut method for calculating the pool of windfall tax benefits.

The following table illustrates the proforma effect on operating results and per share information had the Company accounted for stock-based compensation in accordance with SFAS 123(R), for the twelve month period ended December 31, 2005 (in thousands except per share amounts).

| | Year Ended December 31, 2005 |
|--|---|
| Net loss: | <i>(In thousands)</i> |
| Net loss as reported | (\$498) |
| Stock-based compensation under FAS 123 | (135) |
| Proforma net loss | (\$633) |
| Basic and diluted loss per share: | |
| As reported | (\$0.14) |
| Pro forma | (\$0.18) |

2. Summary of Significant Accounting Policies (Continued)

Stock Options

The Company uses the Black-Scholes and Binomial Lattice option pricing models for service based and market based options, respectively, to estimate the fair value of stock-based awards with the weighted average assumptions noted in the following table.

| | December 31, 2006 | December 31, 2005 |
|-------------------------|----------------------|----------------------|
| Black-Scholes Model: | | |
| Risk-free interest rate | 3.2% | 3.4% |
| Expected life, in years | 3.7 | 3.4 |
| Expected volatility | 87.43% | 80.07% |
| Dividend yield | 0.00% | 0.00% |
| Binomial Model: | | |
| Risk-free interest rate | 3.64% | -- |
| Expected life, in years | 6.0 | -- |
| Expected volatility | 136.18% | -- |
| Dividend yield | 0.00% | -- |

Expected volatility is based on the historical volatility of the Company's share price in the period prior to option grant equivalent to the expected life of the options. The expected term is based on management's estimate of when the option will be exercised which is generally consistent with the vesting period. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

Use of Estimates

Preparation of the Company's consolidated financial statements requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and related revenues and expenses. Actual results could differ from those estimates.

Advertising and Promotion

Product costs for promotional samples are classified in the statement of operations as sales and marketing expense. Costs associated with the purchase of tradeshow booths and equipment are included in capitalized property and equipment and depreciated over their estimated useful lives. All other advertising costs are expensed as incurred. Sales and marketing expenses include advertising expense of \$959,000 and \$825,000 for the years ended December 31, 2006 and 2005, respectively.

Deferred Rent

Rent expense is recognized on a straight line basis over the term of the lease. The difference between rent expense recognized on the straight line basis and rent actually paid under the terms of the lease agreement is recorded as a deferred rent liability in the accompanying balance sheet.

2. Summary of Significant Accounting Policies (Continued)

Reclassifications

Certain amounts in the 2005 statement of operations and notes to the consolidated financial statements have been reclassified to conform with the 2006 presentation.

3. New Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes--an Interpretation of FASB Statement 109 ("FIN 48"), which clarifies the accounting for uncertainty in tax positions. This Interpretation provides that the tax effects from an uncertain tax position can be recognized in the Company's financial statements, only if the position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of fiscal 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact, if any, of adopting FIN 48 on its financial statements.

In September 2006, FASB issued Statement 157, Fair Value Measurements. This statement defines fair value and establishes a framework for measuring fair value in generally accepted accounting principles (GAAP). More precisely, this statement sets forth a standard definition of fair value as it applies to assets or liabilities, the principal market (or most advantageous market) for determining fair value (price), the market participants, inputs and the application of the derived fair value to those assets and liabilities. The effective date of this pronouncement is for all full fiscal and interim periods beginning after November 15, 2007. The Company is currently evaluating the impact of adopting FASB Statement 157 on its financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 "*Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*". This bulletin requires companies to consider the effect of prior year misstatements for past and current financial statements when determining the materiality of these misstatements, and to make appropriate adjustments to the financial statements and related disclosures accordingly. This requirement is in effect for all companies with fiscal years ending on or before November 15, 2006. The Company adopted SAB No. 108 during the fourth quarter of 2006. As a result of this adoption the Company has reduced its accrual for audit fees by \$50,000 in 2006.

Inventories

Inventories consist of the following:

| | December 31, | |
|--------------------------|-----------------------|-------------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Components | \$330 | \$407 |
| Finished goods | 146 | 95 |
| Reserve for obsolescence | (129) | (67) |
| | \$347 | \$435 |

4. Supplemental Balance Sheet Information (Continued)

Property and Equipment

Property and equipment consists of the following:

| | December 31, | |
|---------------------------------|-----------------------|-------------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Computer equipment and software | \$2,614 | \$2,118 |
| Office furniture and other | 404 | 355 |
| | 3,018 | 2,473 |
| Less accumulated depreciation | (2,355) | (2,150) |
| | \$663 | \$323 |

Depreciation expense for years ended December 31, 2006 and 2005 was \$238,763 and \$155,602 respectively.

The Company has financed some of its equipment through capital lease contracts. Leased property and equipment includes \$29,000 and \$30,000 of gross assets held as capital leases which had accumulated depreciation of \$5,000 and \$26,000 as of December 31, 2006, and 2005, respectively.

Capitalized Software Products

Capitalized software products are as follows:

| | December 31, | |
|--|-----------------------|-------------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Software translation | \$125 | \$125 |
| SmartMusic website | 461 | 461 |
| Impact development | 403 | 0 |
| Repertoire development | 1,209 | 960 |
| | 2,198 | 1,546 |
| Less accumulated depreciation and amortization | (1,244) | (1,075) |
| | \$954 | \$471 |

Amortization expense related to the capitalized software was \$165,000 and \$159,000 for the years ended December 31, 2006, and 2005, respectively. Of the remaining \$954,000 in capitalized software, \$740,000 is for Impact and repertoire development in progress that has not yet been released into a current product. When the content that is currently in development is released into current product from time to time, these additional amounts will also be amortized over three years on a straight-line basis. The estimated future amortization expense for existing capitalized software is as follows:

| | |
|-----------------------|--------------|
| <i>(In thousands)</i> | |
| 2007 Amortization | \$274 |
| 2008 Amortization | 349 |
| 2009 Amortization | 249 |
| 2010 Amortization | 82 |
| | \$954 |

4. Supplemental Balance Sheet Information (Continued)

Goodwill

Goodwill of \$3,630,000, net of amortization prior to the adoption of FAS 142, resulted from the reverse merger of Net4Music S.A. with Coda in 2000. On an annual basis, the Company analyzes the value of goodwill by comparing the Company's market value to its book equity to determine if any impairment has occurred. The analyses completed for the years ending December 31, 2006, and 2005 indicated no impairment had occurred in either year.

Other intangible Assets

Other intangible assets are as follows:

| | December 31, | |
|-------------------------------|-----------------------|---------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Distributor/dealer network | \$1,440 | \$1,440 |
| Software products | 2,304 | 2,304 |
| Customer lists | 780 | 780 |
| Total gross value | 4,524 | 4,524 |
| Less accumulated amortization | (4,524) | (4,524) |
| | \$0 | \$0 |

The Company has removed all references in its advertising and literature to Coda Music Technologies or the Coda division of MakeMusic. Therefore, the Coda Trade Name intangible asset was deemed to have no future value and the remaining unamortized balance of \$78,000 was written off during the year ended December 31, 2004.

Amortization expense related to the intangible assets was \$0 and \$725,000 in the years ended December 31, 2006, and 2005, respectively. As of December 31, 2005, other intangible assets were fully amortized.

Other Non-current Assets

Other non-current assets, net, consist of the following:

| | December 31, | |
|------------------------|-----------------------|------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Patents and trademarks | \$28 | \$34 |
| Prepaid royalties | 11 | 32 |
| | \$39 | \$66 |

Deferred Revenue

Deferred revenue is composed of the unearned portion of SmartMusic subscriptions lasting more than one month, deferrals of Finale notation revenue for free upgrades granted to customers purchasing Finale immediately prior to release of a new version, deposits for commission on sheet music revenue sold by partners that received referrals from the MakeMusic websites and deposits for royalties earned from partners incorporating MakeMusic products into their sales items.

4. Supplemental Balance Sheet Information (Continued)

| | December 31, | |
|--|-----------------------|--------------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Deferred SmartMusic subscription revenue | \$1,094 | \$836 |
| Deposits | 68 | 73 |
| Deferred notation revenue | 37 | 7 |
| | \$1,199 | \$916 |

Other Accrued Liabilities

Other accrued liabilities are composed of accrued compensation, accrued royalties, and other miscellaneous accrued liabilities. The company had the following accrued liabilities:

| | December 31, | |
|-------------------|-----------------------|--------------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Accrued royalties | 22 | 34 |
| Other | 232 | 130 |
| | \$254 | \$164 |

5. Shareholders' Equity

Stock Options and Warrants

The Company has a Stock Option Plan (the 2003 Plan) pursuant to which options for up to 950,000 shares of its common stock may be issued to its key employees and directors. The options generally may not exceed 10 years and are granted at prices that must be at least equal to the stock's fair market value at the grant date. The Company's previous stock option plan (the 1992 Plan) expired September 28, 2002, which allowed up to 267,500 shares of its common stock to be issued to key employees and directors. All options vest over periods of up to six years and were granted at prices that must be at least equal to the stock's fair market value at the grant date. There were 641,485 options outstanding under the 2003 plan and 30,010 options outstanding under the 1992 plan as of December 31, 2006.

The following table represents stock option activity for the twelve months ended December 31, 2006:

| | Shares Reserved for Grant | Plan Options | Weighted Average Exercise Price | Weighted Average Remaining Contract Life |
|--|---------------------------------|-----------------|--|---|
| Outstanding at December 31, 2005 | 16,675 | 712,473 | \$3.96 | |
| Granted | (42,000) | 42,000 | \$7.33 | |
| Expired | -- | (20,900) | \$16.79 | |
| Cancelled | 34,144 | (34,144) | \$3.82 | |
| Exercised | -- | (27,934) | \$3.18 | |
| Authorized | 200,000 | 0 | -- | |
| Outstanding at December 31, 2006 | <u>208,819</u> | <u>671,495</u> | <u>\$3.81</u> | <u>4.0 Years</u> |
| Outstanding exercisable at December 31, 2006 | <u>--</u> | <u>316,939</u> | <u>\$3.95</u> | <u>3.5 Years</u> |

5. Shareholders' Equity (Continued)

The weighted-average fair value of options granted during 2006 and 2005 (computed using the Black-Scholes method) was \$4.27 and \$1.86, respectively.

The following summarizes information about stock options outstanding at December 31, 2006:

| Range of Exercise Prices | | | Options Outstanding | | | Options Exercisable | |
|--------------------------|----|--------------------|--|-------------------------|--------------------|-------------------------|---------|
| From | to | Number Outstanding | Weighted Remaining Contractual Life (in Years) | Weighted Exercise Price | Number Outstanding | Weighted Exercise Price | |
| \$2.27 | to | \$2.27 | 265,003 | 3.52 | \$2.27 | 122,204 | \$2.27 |
| \$2.27 | to | \$3.50 | 134,229 | 3.37 | \$2.55 | 100,667 | \$2.50 |
| \$3.51 | to | \$10.00 | 231,053 | 5.20 | \$4.44 | 67,108 | \$4.21 |
| \$10.01 | to | \$20.00 | 33,410 | 3.26 | \$10.58 | 19,160 | \$10.78 |
| \$20.01 | to | \$35.00 | 7,800 | 0.20 | \$29.87 | 7,800 | \$29.87 |
| Total | | | 671,495 | 4.02 | \$3.81 | 316,939 | \$3.95 |

In August 2001, the Company issued 6,500 options to purchase common stock at \$7.50 to third parties in exchange for advisory and promotional services. Of these options, 4,000 vested immediately and the remaining 2,500 shares vest over 60 months as advisory services are received. In connection with these issuances the Company has recognized expenses of \$270 and \$682, for 2006 and 2005, respectively. As the remaining options vest the Company will recognize additional expenses.

At December 31, 2006 the aggregate intrinsic value of options outstanding was \$1,780,000, and the aggregate intrinsic value of options exercisable was \$911,000. Total intrinsic value of options exercised was \$73,000 for the twelve months ended December 31, 2006. At December 31, 2006 there was \$168,000 of unrecognized compensation cost related to nonvested share-based payments which is expected to be recognized over a weighted-average period of 1.95 years.

In October 2001, the Company issued warrants to purchase 15,000 shares of common stock at \$6.60 to a third party in exchange for advisory and promotional services. The warrants vest over 60 months. During 2006 and 2005, the Company has recognized expenses in the amount of \$10,866 and \$6,683, respectively, in relation to the vested portion of warrants.

There were no new warrants issued during 2006 or 2005. Total warrants of 629,228, at a weighted average exercise price of \$2.91, are outstanding at December 31, 2006, all of which are exercisable. The warrants expire as follows:

2008 – 599,145
2010 – 15,083
2011 – 15,000

6. Commitments

Capital Lease Obligations

Future minimum lease payments under capital lease obligations due for the years ending December 31 are as follows (in thousands):

| | |
|---|--------------|
| 2007 | \$ 10 |
| 2008 | 10 |
| 2009 | <u>6</u> |
| Total minimum lease payments | 26 |
| Less amount representing interest | <u>1</u> |
| Present value of net minimum lease payments | 25 |
| Less current portion | <u>10</u> |
| Long-term portion | <u>\$ 15</u> |

Operating Leases

The Company leases office and warehouse space and certain equipment under operating leases. Total future minimum lease payments under these leases as of December 31, 2006, are as follows (in thousands):

| | |
|-------|---------------|
| 2007 | \$ 185 |
| 2008 | 186 |
| 2009 | 190 |
| 2010 | 192 |
| 2011 | <u>48</u> |
| Total | <u>\$ 801</u> |

Rent expense, including common area maintenance expense for the years ended December 31, 2006, and 2005 was \$280,000 and \$302,000, respectively.

7. 401(k) Savings Plan

The Company has a 401(k) savings plan for the benefit of qualified U.S. employees. Under the plan, qualified employees may elect to defer up to 80% of their compensation, subject to a limit determined by the Internal Revenue Service. The Company, at the discretion of the Board of Directors, may elect to make additional discretionary contributions. The Company made no contributions to the plan in 2006 or 2005.

8. Income Taxes

The tax effects of temporary differences for 2006 and 2005 at an assumed effective annual rate of 36% and 38% (combined Federal rate and state tax rate), respectively, are shown in the following table:

| | December 31, | |
|---|-----------------------|---------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Deferred tax assets: | | |
| Loss carry-forwards | \$7,472 | \$8,113 |
| Research and development credits | 875 | 736 |
| Inventory | 47 | 26 |
| Depreciation and amortization | 116 | 115 |
| Deferred revenue | 407 | 348 |
| Software development and prepaid royalties | 89 | 90 |
| Accrued expenses | 390 | 350 |
| Accounts receivable | 53 | 6 |
| Valuation allowance for deferred tax assets | (9,066) | (9,567) |
| Net deferred tax assets | \$383 | 217 |
| Deferred tax liabilities: | | |
| Software development costs | 383 | 217 |
| Net deferred taxes | \$ - | \$ - |

Realization of deferred tax assets is dependent upon the generation of sufficient future taxable income. Management has determined that sufficient uncertainty exists regarding realizability of the net deferred tax assets and has provided a valuation allowance against all of the net deferred tax assets.

A reconciliation of the income tax benefit computed using the U.S. statutory rate (34%) to the effective income tax expense included in the statement of operations is as follows:

| | December 31, | |
|---|-----------------------|-----------------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Income tax expense computed at the statutory rate | \$ 90 | \$ (169) |
| State tax expense, net of calculated Federal income tax effects | 5 | (21) |
| Change in deferred tax rate | 463 | -- |
| Prior year change in NOL's carryforward | 28 | -- |
| Prior Year and Current Year R&D Credits | (139) | -- |
| Change in Valuation Allowance | (501) | 174 |
| Permanent differences | 56 | 17 |
| Other | 7 | -- |
| Income tax expense | \$ 9 | \$ 1 |

8. Income Taxes (Continued)

Net Operating Losses

At December 31, 2006, the Company had net operating loss carry-forwards (NOLs) and research and development credit carry-forwards which may be used to offset otherwise future taxable income with the following expiration dates (in thousands):

| | Net Operating Loss | Research and Development Credits |
|------|--------------------|-------------------------------------|
| 2007 | 0 | 13 |
| 2008 | 0 | 72 |
| 2009 | 1,576 | 90 |
| 2010 | 2,128 | 47 |
| 2011 | 2,192 | 43 |
| 2012 | 1,736 | 38 |
| 2018 | 770 | 46 |
| 2019 | 1,472 | 36 |
| 2020 | 4,414 | — |
| 2021 | 3,037 | 72 |
| 2022 | 1,375 | 116 |
| 2023 | 2,056 | 72 |
| 2024 | 0 | 91 |
| 2025 | 0 | 68 |
| 2026 | 0 | 71 |
| | <u>\$20,756</u> | <u>\$875</u> |

Section 382 of the Internal Revenue Code restricts the annual utilization of these NOLs incurred prior to a change in ownership. Such a change in ownership occurred in connection with the Coda reverse merger, thereby potentially restricting the NOLs available to the Company. The Company has yet to determine whether any limitation on these NOLs exists at December 31, 2006.

9. Litigation

In the ordinary course of business, the Company may be party to legal actions, proceedings or claims. Corresponding costs are accrued when it is probable that a loss will be incurred and the amount can be precisely or reasonably estimated. The Company is currently not aware of any threatened or actual litigation that would have a material affect on its financial condition or results of operations.

10. Segment and Geographic Data

The Company operates in one industry segment: the design, development, support and marketing of application solutions to music educators, music-makers and the music publishing industry. The Company provides the technologies, products and services to optimize the entire music-maker supply chain.

10. Segment and Geographic Data (Continued)

The geographic distribution of the Company's revenues and long-lived assets are summarized in the following table:

| | December 31, | |
|-------------------------|-----------------------|------------------|
| | 2006 | 2005 |
| | <i>(In thousands)</i> | |
| Net sales: | | |
| North America | \$ 10,740 | \$ 9,370 |
| Europe | 1,165 | 1,102 |
| Other foreign countries | 1,073 | 1,345 |
| | \$ 12,978 | \$ 11,817 |
| Long-lived assets: | | |
| North America | \$ 5,286 | \$ 4,490 |

11. Liquidity

Net cash provided by operating activities was \$1,148,000 for the year ended December 31, 2006, compared to \$451,000 provided by operating activities for the year ended December 31, 2005. The Company expects to continue to generate positive operating cash flow in the foreseeable future, but not necessarily every quarter. If the Company does not meet its anticipated revenue levels due to a significantly later-than-anticipated notation product release or a decrease in demand for its products, management is committed to expense reductions in sales, marketing and other areas as necessary to ensure adequate cash levels remain to continue funding operations. If further expense reductions do not offset such a decrease in revenue, the Company may have to seek additional financing. There can be no assurances that such financing will be available on attractive terms or at all.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

NONE

ITEM 8A. CONTROLS AND PROCEDURES

Our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) as of the end of the period covering this report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Securities and Exchange Commission's rules and forms.

Changes in Internal Controls

There were no changes in the Company's internal control over financial reporting that occurred during the fourth quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 8B. OTHER INFORMATION

All information required to be reported in a report on Form 8-K during the fourth quarter of the year covered by this report has been reported; however, on February 15, 2007, the Board adopted a compensation plan for directors who are not employees or representatives of more than 5% holders of the Company's stock (the "Eligible Directors"). The plan provides for director fees in the amount of \$3,000 per quarter and an additional \$2,000 per quarter for serving as chair of any of the Board committees. In addition, each Eligible Director received a four-year option to purchase 4,000 shares of the Company's common stock. The full text of the plan is set forth in Exhibit 10.18 to this form 10-KSB and is incorporated by reference herein. Additionally, an employment agreement was executed on February 26, 2007 between the Company and Ron Raup, President and Chief Operating Officer. The full text of the agreement is set forth in Exhibit 10.1 to our 8-K filed March 1, 2007 and is incorporated by reference herein.

PART III

ITEM 9. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The names and ages of the executive officers of the Company and their positions and offices presently held are as follows:

| <u>Name</u> | <u>Age</u> | <u>Position</u> |
|----------------------|------------|---------------------------------------|
| John W. Paulson | 58 | Chief Executive Officer |
| Ronald B. Raup | 56 | President and Chief Operating Officer |
| Karen L. VanDerBosch | 43 | Chief Financial Officer and Treasurer |

John W. Paulson, founder of MakeMusic, has served as a Company director, Chairman and CEO from 1990 to 2000 and continues to serve as CEO and a director. From 1982 to 1990, Mr. Paulson was Chairman and CEO of Springboard Software, Inc., a publicly held company he founded to develop and market educational consumer software products. Prior to founding Springboard, Mr. Paulson was a public school music teacher for nine years. He has a Master of Arts in Music Education from the Eastman School of Music, is a published composer and has performed as a professional musician for more than 10 years. Mr. Paulson has served on the Board of Directors of the National Association of Music Merchants, the Wenger Corporation and the St. Paul Chamber Orchestra.

Ronald B. Raup, has served as our President and Chief Operating Officer and director since October 2006. Prior to then Mr. Raup served as Chief Marketing Officer from September 2005 until October 2006, and as a member of our Board of Directors from September 2004 until September 2005. Mr. Raup most recently served as Vice President of Brook Mays Music Company, the largest full-line music products retailer in North America. Prior to Brook Mays, Mr. Raup was employed by MakeMusic where he served as President and Chief Operating Officer from 1995 until 1999. Before that, Mr. Raup was Senior Vice President of Marketing and Sales at Yamaha Corporation of America, the largest music products company in the world. He also served on Yamaha's Board of Directors. Mr. Raup has served on various industry boards including the International Association of Music Merchants.

Karen L. VanDerBosch, joined the Company as Chief Financial Officer and Treasurer in December 2006. Ms. VanDerBosch was most recently the CFO of Sagebrush Corporation, a privately held developer of library automation software and services, analytical software and book re-binder for the K-12 education market. Ms. VanDerBosch previously served as CFO for KB Gear Interactive, a privately held developer and marketer of interactive digital devices and applications serving retail markets. Her extensive background in manufacturing and technology industries also included CFO positions at EMPAK Inc. and the publicly traded Fieldworks Inc.

Additional information required by Item 9 relating to directors, compliance with Section 16(a) of the Exchange Act, and code of ethics is incorporated herein by reference to the sections labeled "Election of Directors," "Section 16(a) Beneficial Ownership Reporting Compliance" and "Code of Ethics and Business Conduct," that appear in the Company's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders. Such information is incorporated herein by reference.

ITEM 10. EXECUTIVE COMPENSATION

The information required by this Item 10 is contained in the section entitled "Executive Compensation" in the Company's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders. Such information is incorporated herein by reference.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item 11 regarding security ownership of certain holders is contained in sections entitled “Principal Shareholders” and “Management Shareholdings” that appear in the Company’s definitive Proxy Statement for its 2007 Annual Meeting of Shareholders. Such information is incorporated herein by reference.

The following table provides information concerning the Company’s equity compensation plans as of December 31, 2006.

| | Number of securities to be issued upon exercise of outstanding options. | Weighted average exercise price of outstanding options. | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|--|---|---|---|
| | (a) | (b) | (c) |
| Equity compensation plans approved by security holders | 671,495 | \$ 4.02 | 208,819 |
| Totals | 671,495 | \$ 4.02 | 208,819 |

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item 12 contained in the section entitled “Certain Transactions and Business Relationships” that appears in the Company’s definitive Proxy Statement for its 2007 Annual Meeting of Shareholders. Such information is incorporated herein by reference.

ITEM 13. EXHIBITS

See “Exhibit Index” immediately following the certifications to this Form 10-KSB for a description of the documents that are filed as Exhibits to this report on Form 10-KSB or incorporated by reference herein.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item 14 is contained in the section entitled “Independent Registered Public Accounting Firm, Audit Fees” that appears in the Company’s definitive Proxy Statement for its 2007 Annual Meeting of Shareholders. Such information is incorporated herein by reference.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the Registrant has caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

MakeMusic, Inc.

Dated: March 15, 2007

By: /s/ John W. Paulson
John W. Paulson, Chief Executive Officer

In accordance with the Exchange Act, this Report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

(Power of Attorney)

Each person whose signature appears below constitutes and appoints John W. Paulson and Karen L. VanDerBosch as true and lawful attorneys-in-fact and agents, each acting alone, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any or all amendments to this Annual Report on Form 10-KSB and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, each acting alone, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all said attorneys-in-fact and agents, each acting alone, or his substitute or substitutes, may lawfully do or cause to be done by virtue thereof.

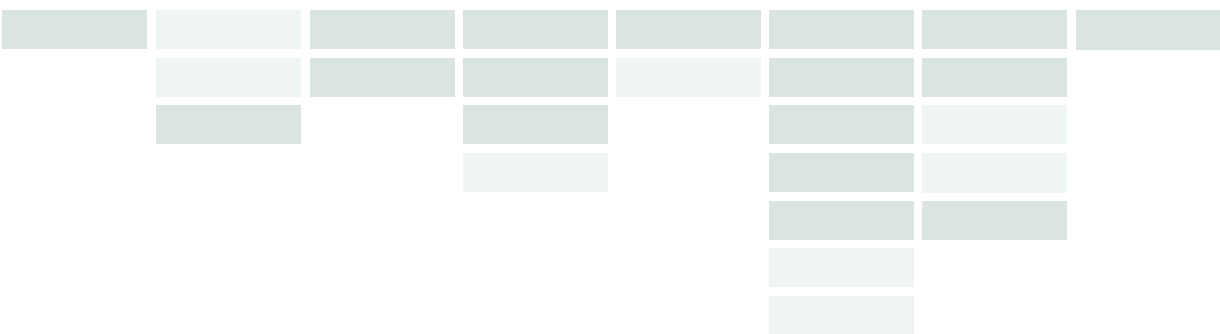
| <u>Signature and Title</u> | <u>Date</u> |
|--|--------------------|
| <u>/s/ John W. Paulson</u> John W. Paulson, Chief Executive Officer and Director | March 15, 2007 |
| <u>/s/ Ronald B. Raup</u> Ronald B. Raup, President, Chief Operating Officer and Director | March 15, 2007 |
| <u>/s/ Karen L. VanDerBosch</u> Karen L. VanDerBosch, Chief Financial Officer | March 15, 2007 |
| <u>/s/ Jeffrey A. Koch</u> Jeffrey A. Koch, Chairman of the Board, Director | March 15, 2007 |
| <u>/s/ Graham Richmond</u> Graham Richmond, Director | March 15, 2007 |
| <u>/s/ Michael R. Skinner</u> Michael R. Skinner, Director | March 15, 2007 |
| <u>/s/ Lawrence M. Morton</u> Lawrence M. Morton, Director | March 15, 2007 |
| <u>/s/ Keith A. Fenhaus</u> Keith A. Fenhaus, Director | March 15, 2007 |

**MAKEMUSIC, INC.
EXHIBIT INDEX FOR
FORM 10-KSB FOR 2006 FISCAL YEAR**

| <u>Exhibit Number</u> | <u>Description</u> |
|----------------------------------|---|
| 3.1 | Restated Articles of Incorporation as amended – incorporated by reference to Exhibit 3.1 to the Registrant’s Form 10-QSB for the quarter ended June 30, 2006 |
| 3.2 | Bylaws as amended - incorporated by reference to Exhibit 3.2 to the Registrant’s Form 10-QSB for the quarter ended June 30, 2006 |
| 10.1 | License Agreement dated June 10, 1992, between the Registrant and Carnegie Mellon University, including Amendments 1 and 2—incorporated by reference to Exhibit 10.11 to the Registrant’s Form SB-2 Registration Statement, Reg. No. 33-92212C |
| 10.2 | License Agreement dated December 31, 1992, between the Registrant and Wenger Corporation—incorporated by reference to Exhibit 10.12 to the Registrant’s Form SB-2 Registration Statement, Reg. No. 33-92212C |
| 10.3* | Form of Nonqualified Stock Option Agreement for Options Granted Outside the 1992 Stock Option Plan—incorporated by reference to Exhibit 10.13 to the Registrant’s Form SB-2 Registration Statement, Reg. No. 33-92212C |
| 10.4 | Amendment No. 3 to License Agreement between the Registrant and Carnegie Mellon University dated August 28, 1996 — incorporated by reference to Exhibit 10.1 to the Registrant’s 10-QSB for the quarter ended September 30, 1996 |
| 10.5 | Amendment No. 4 to License Agreement between the Registrant and Carnegie Mellon University dated December 30, 1998 — incorporated by reference to Exhibit 10.10 to the Registrant’s Form 10-KSB for the year ended December 31, 1998 |
| 10.6* | Employment Agreement dated October 19, 2000 between the Registrant and John W. Paulson — incorporated by reference to Exhibit 10.15 to the Registrant’s Form 10-KSB for the year ended December 31, 2000 |
| 10.7 | MakeMusic, Inc. 2003 warrant for private placement at \$3.20 issued February 28, 2003, with list of amounts purchased by directors, officers and principal shareholders – incorporated by reference to exhibit 10.15 to the Registrant’s Form 10-KSB for the year ended December 31, 2002 |
| 10.8 | MakeMusic, Inc. 2003 warrant for private placement at \$0.50 issued February 28, 2003, with list of amounts purchased by directors, officers and principal shareholders – incorporated by reference to exhibit 10.16 to the Registrant’s Form 10-KSB for the year ended December 31, 2002 |
| 10.9* | MakeMusic, Inc. 2003 Equity Incentive Plan, as amended – incorporated by reference to exhibit 10.17 to the Registrant’s Form 10-KSB for the year ended December 31, 2003 |
| 10.10* | Employment Agreement dated June 9, 2004, between the Registrant and William R. Wolff – incorporated by reference to Exhibit 10.18 to the Registrant’s Form 8-K filed on May 18, 2006 |
| 10.11* | Board Compensation Plan effective January 23, 2006 – incorporated by reference to Exhibit 10.20 to the Registrant’s Form 10-KSB for the year ended December 31, 2005 |
| 10.12* | Form of Incentive Stock Option Agreement under the MakeMusic! 2003 Equity Incentive Plan – incorporated by reference to Exhibit 10.21 to the Registrant’s Form 10-KSB for the year ended December 31, 2004 |

| <u>Exhibit Number</u> | <u>Description</u> |
|----------------------------------|---|
| 10.13* | Form of Nonqualified Stock Option Agreement under the MakeMusic! 2003 Equity Incentive Plan – incorporated by reference to Exhibit 10.22 to the Registrant’s Form 10-KSB for the year ended December 31, 2004 |
| 10.14* | Form of Restricted Stock Agreement under the MakeMusic! 2003 Equity Incentive Plan – incorporated by reference to Exhibit 10.23 to the Registrant’s Form 10-KSB for the year ended December 31, 2004 |
| 10.15* | Separation Agreement of Alan Shuler – incorporated by reference to Exhibit 10.1 to the Registrant’s Form 10-QSB for the quarter ended September 30, 2006 |
| 10.16* | Separation Agreement and Release with William R. Wolff – incorporated by reference to the Registrant’s Form 8-K filed on December 19, 2006 |
| 10.17* | Employment Agreement dated February 26, 2007, between the Registrant and Ronald B Raup – incorporated by reference to the Registrant’s Form 8-K filed on March 1, 2007 |
| 10.18* | Board Compensation Plan effective February 15, 2007 – filed herewith |
| 23.1 | Consent of McGladrey & Pullen LLP, independent registered public accounting firm |
| 24 | Power of Attorney (included on the “Signatures” page of this Form 10-KSB) |
| 31.1 | Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification by Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification by Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

*Indicates a management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-KSB.



corporate shareholder information

STOCK MARKET
THE NASDAQ STOCK MARKET
SYMBOL: MMUS

ANNUAL SHAREHOLDERS' MEETING
WEDNESDAY, MAY 23, 2007, 3:30 P.M.
FREDRIKSON & BYRON
SUITE 4000
200 SOUTH SIXTH STREET
MINNEAPOLIS, MN 55402

REGISTRAR AND TRANSFER AGENT
WELLS FARGO BANK, NA
SHAREOWNER SERVICES
161 NORTH CONCORD EXCHANGE
SOUTH ST. PAUL, MN 55075
TELEPHONE: 800.468.9716

DIVIDENDS
MAKEMUSIC HAS NEVER PAID CASH DIVIDENDS
ON ITS COMMON STOCK AND CURRENTLY
INTENDS TO RETAIN ANY EARNINGS TO FUND
ITS OPERATIONS.

LEGAL COUNSEL
FREDRIKSON & BYRON, PA

INDEPENDENT AUDITORS
MCGLADREY & PULLEN, LLP

INVESTOR INFORMATION
FORMS 10-KSB AND 10-QSB, PROXY STATEMENTS,
AND OTHER INVESTOR INFORMATION ARE AVAILABLE
AT NO CHARGE THROUGH ONE OF THE FOLLOWING:

WEB: WWW.MAKEMUSIC.COM
E-MAIL: INVESTORRELATIONS@MAKEMUSIC.COM
PHONE: 952.906.3690
800.843.2066, EXT. 3690
FAX: 952.906.3617
MAIL: MAKEMUSIC, INC. INVESTOR RELATIONS
7615 GOLDEN TRIANGLE DRIVE, SUITE M
EDEN PRAIRIE, MN 55344-3848

board of directors

JEFFREY A. KOCH
CHAIRMAN OF THE BOARD
CHIEF EXECUTIVE OFFICER
LAUNCHEQUITY PARTNERS, LLC

JOHN W. PAULSON
CHIEF EXECUTIVE OFFICER
MAKEMUSIC, INC.

KEITH A. FENHAUS
PRESIDENT
HALLMARK INSIGHTS

LAWRENCE M. MORTON
PRESIDENT
HAL LEONARD CORPORATION

RONALD B. RAUP
PRESIDENT &
CHIEF OPERATING OFFICER
MAKEMUSIC, INC.

GRAHAM RICHMOND
CHIEF EXECUTIVE OFFICER &
CO-FOUNDER
CLEAR ADMIT, LLC

MICHAEL SKINNER
PRESIDENT
DANSR

corporate officers and executive management

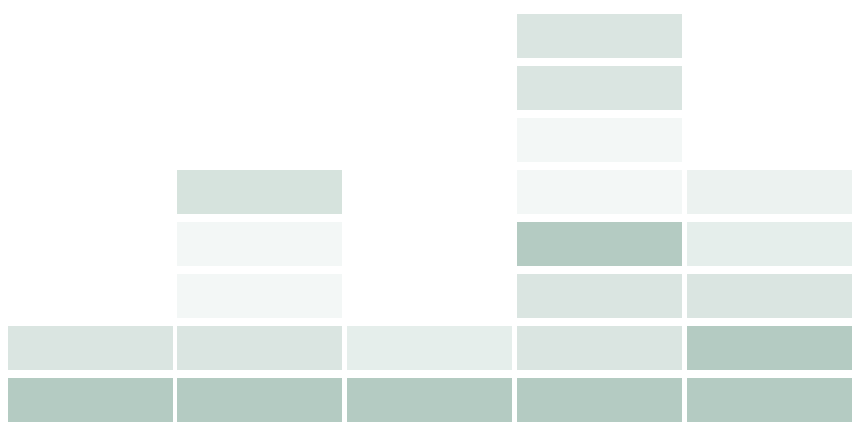
JOHN W. PAULSON
CHIEF EXECUTIVE OFFICER

RONALD B. RAUP
PRESIDENT &
CHIEF OPERATING OFFICER

KAREN L. VANDERBOSCH
CHIEF FINANCIAL OFFICER

MARK E. DUNN
CHIEF TECHNOLOGY OFFICER

MARY B. SCHNEIDER
CHIEF MARKETING OFFICER



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